RELEVANCE OF ISLAMIC BANKING SYSTEM IN THE PRESENT ECONOMIC SCENARIO

Abstract

The economic growth of a civil society depends largely on the displacement of fiscal deposits from depositors to investors so as to sustain developmental projects boosting the socio-economic development. In any economy, banks play a very important role. Banks were traditionally differentiated from other financial institutions by their principal functions of accepting deposits subject to withdrawal or transfer and of making loans. Islamic banking is built around Shariah, mainly prohibiting the charging of interest. Islam considers interest an unjustified increase of capital, with no effort made to earn it; it is considered of false value, and, therefore, prohibited. In simple words, Islamic banks operate in interest-free system. Prohibition of interest is ordained in Islam in all forms intent. This prohibition is strict, absolute and unambiguous. Looking at the inadequacies of the prevailing economic system, in promoting real economic well-being of the masses, Muslims all over the world stared to re-discover the wisdom and balance of Islamic economic system. An Islamic bank is a financial institution which identifies itself with the spirit of Shariah, as laid down by the Holy Qur'an and Sunnah. To replace interest, the ideal mode of financing under the Islamic banking system is "Financing on Profit & Sharing" (PLS) basis. There could be no denying of the fact that under the interest-based system of banking or in a system not strictly based on the principles and spirit of Shariah, depositors as well as borrowers are exploited in one form or the other. Islamic finance in general, and Islamic banking in particular, could be the only solace in the present economic scenario as it can be used as an alternative system whose operations are based on interest free mechanism.

I Introduction

FINANCIAL ARRANGEMENTS constitute an integral part of the process of economic development. A growing economy requires a progressively rising volume of savings and adequate institutional arrangements for the mobilization and allocation of savings. These arrangements must not only extend and expand but also adapt to the growing and varying financial needs of the economy. A well-developed and efficient capital market is an indispensable pre-requisite for the effective allocation of savings in an economy. A financial system consisting of financial institutions, instruments and market provides an effective payment and credit supply network thereby assists in channelling of funds from savers to the investors in the economy. The task of the financial institutions or intermediaries is to mobilize the savings and ensure efficient allocation of these savings to high yielding investment project so that they are in a position to offer attractive returns to the savers.[1]

It is true that external financing is of utmost importance for almost every kind of business in an economy and banking industry is the main facilitator in this regard. Primarily, the banking is business of dealing in money and instruments of credit. Banks were traditionally differentiated from other financial institutions by their principal functions of accepting deposits subject to withdrawal or transfer by cheque and of making loans. Islamic banking is built around Shariah, mainly prohibiting the charging of interest. Because Islam considers interest an unjustified increase of capital, with no effort made to earn it, it is considered of false value, and is, therefore, prohibited. Islamic banking can be considered banking with a conscience. Islamic banks each have a Shariah board made up of Shariah scholars as well as financial experts who are responsible for determining what activities are or are not Shariah-compliant.

II Islamic banking system and present economic scenario: An analysis

The economic growth of a civil society largely depends on the displacement of fiscal deposits from depositors to investors so as to sustain developmental projects boosting the socio-economic development. In any economy, banks play very important role. A bank is a reliable financial institution, which has core business of mobilizing the savings of people for investment. It receives the money from one group and lends to other groups of people. We can say that these financial institutions operate like an intermediary between depositors and investors. Bank as a monetary institution is as old as human society because the moment a man realizes the importance of money as a medium of exchange, the

1. M. Muslehuddin, *Banking and Islamic Law* ix (Idara Isha'at-e-Diniyat (P) Ltd.,New Delhi, India 2007).

necessity for an agency to regulate, control and facilitate was naturally felt. In recent years, financial institutions have experienced a dynamic, fast-paced, and competitive environment at a cross-border scale. One of the most growing parts is the paradigm of Islamic banking which has remarkably captured the interest of both Islamic and contemporary economists. The main difference of Islamic banks with contemporary banks is that while the latter is based on the conventional interest-based principle, the former follows a principle of interest free and profit and loss sharing system in performing their business as intermediaries.[2] In simple words, Islamic banks operate in interest free system. Prohibition of interest is ordained in Islam in all forms. This prohibition is strict, absolute and unambiguous. Islam is not simply one of the greatest monotheistic religions, signifying submission to the will of Allah, but as a system of life in its entirety. It prescribes a complete code of conduct for every day human life in all its spheres and manifestations.[3] It does not confine itself to a spiritual relationship between man and Allah or describes the Almighty only with a transcendental reference but also regulates the behaviour of man and man, and between man and society with moral, political and economic genesis. As a result, it is a religion lived in everyday life and no Muslim is in any doubt as to exactly how he should carry on the events of his daily life.

The main object of Islam is to remove the economic stratification of society so that goal of socio-economic development and universal brotherhood is achieved. In Islam, an individual having wealth owes a duty to ensure basic necessities to an individual who is living in misery. Islamic economic system is based on the principle of equal distribution of wealth as the ownership vests in almighty Allah.

On the other hand, capitalism has not been able to narrow down the gap between the "haves" and "have-nots". Material affluence, wherever it exists, is marked by conspicuous absence of a broad based sharing of fortunes and thus real happiness to a large number of people is seriously missing. Likewise, socialism advocating collective ownership of the means of production and control of distribution has failed to provide the necessary motivation for collective development and personal self-actualization, and thus retarded the process and rate of economic growth.

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2. Iqbal Anwar, "Islam and the Theory of Interest", *Islamic Voice*, vol. 13-04, no. 148, p. 30 (Islamic Research Academy, April, 1999).

3. *Id* at 31.

Similarly, communism, stressing ownership of property and control of production, distribution and supply, by the whole of classless society, could not get along with the human potential, dynamism and aspirations, and fell too short to bring about economic satisfaction or progress, in individual and collective life.[4]

Looking at the inadequacies of the prevailing economic system, in promoting real economic well-being of the masses, Muslims all over the world stared to re-discover the wisdom and balance of Islamic economic system. This led to a renaissance, during the last few decades of economic thought and system as enunciated by Islam. The upsurge gained momentum with the discovery of oil and resultant ballooning up of the national income of many Middle East countries. In the process, attention was focused on Islamic economic system, Islamic banking and elimination of interest (*riba*) in conformity with the injunctions contained in the Holy Qur'an and sayings of the Holy Prophet (Peace be upon him).[5]

The revival of Islamic economic system has now become a point of central attention in Islamic world, which covers about one-sixth of the land surface of the globe. The Muslim population by the 2050 A.D. is expected to be over 2.6 billion or over 26 per cent of the projected world population of 10 billion. Islamic finance and its products are nothing but the resultant of religious zeal of Islamic world to find solution as to economic necessities of Muslim population and catering it in parallel with conventional global financial environment. Islamic banking as a key player of Islamic finance is the new buzz word in the global financial market. There are about 270 Islamic banks around the world (including subsidiaries of conventional banks), together they hold assets estimated at more than $ 265 billion and their holdings are growing by 15 per cent a year. The emergence of Islamic banking in recent years is one of the most important trends in the economic sector, and with the estimated 1.6 billion Muslims worldwide, the possibility and probability of its exponential growth in future has been certain and highly speculated by financial analysts. There has always been a demand among Muslims for financial products and services that conform to Shariah (Islamic Law).[6] The

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4. Yahiya Abdul, "Principle of Islamic Banking", *Nida'ul Islam Magazine,Lakemba, Australia*, 10th issue, p. 12 (1995).

5. Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* 38 (E.J. Brill Publishers, Lieden, 1996).

6. Archer Simon *et al.* (eds.), *Islamic Finance: The Regulatory Challenge,s xvii* (John Wiley and Sons (Asia) Pvt. Ltd., Singapore, 2007).

development of viable alternatives to conventional finance increasingly enables Muslims to participate in the financial world without violating their Islamic principles and without bearing the economic oblivion and disparity due to non-compliance with interest based conventional banks.

An Islamic bank is a financial institution which identifies itself with the spirit of Shariah, as laid down by the Holy Qur'an and Sunnah. Normally, from Islamic banking, it is meant the interest free banking system, while conventional banking is perceived as interest based banking system. To replace interest, the ideal mode of financing under the Islamic banking system is "Financing on Profit & Sharing" (PLS) basis.

There could be no denying of the fact that under the interest-based system of banking or in a system not strictly based on the principles and spirit of Shariah, depositors as well as borrowers are exploited in one form or the other, interest is usually paid on borrowed money or, in other words, on debt. In last decades, debt was considered as most effective resource of financing. It was contended that debt has a better control function because the threat of failure to make debt-service payments serves as a strong motivating force.[7] On the other hand, it is considered that, although an increasing level of debt helps the economy grow faster for a while, it foments endogenous instability and financial fragility. Frederic Minsky in his work[8] has propounded and popularized the idea of endogenous instability and financial fragility. That is, initially when the debt equity *ratio* of a corporate is low, it really pays to finance expansion by borrowed funds. At this stage, expectations of both borrower and lender are usually satisfied, or existing debt is validated without any problem, which provides the basis to go further deep in debt. As a result, demand for borrowed funds grows faster than the ability to pay, or in Minskian terminology, the economy moves from hedge to Ponzi finance.[9] Also, demand for further borrowing becomes inelastic because initially, due to the positive slope of term structure, borrowers themselves prefer to borrow on a short-term basis, but later they have to borrow to

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7. Muhammad Najatullah Siddiqi, *Banking Without Interest* 35 (Islamic Research Foundation, Leicester, 1983).

8. Fredric Minsky, *Economic of Money Banking and Financial Market* 76 (Pearson Publications, U.S, 8th ed., 2009).

9. Rahul Dhumale and Amela Sapcanin, "An application of Islamic Banking Principles to Microfinance: A Technical Note", 8-9, A Study by the Regional Bureau for Arab States, UNDP and Middle East and North African Region, World Bank (2005).

keep their existing debt rolling and to fulfill their other committed payments, which in turn, pushes the interest rate up. However, the problem starts when at some point along the line, the supply of credit lags behind the demand. This happens because, on one hand, lenders become pessimistic about future prospects of underlying projects or they no longer share euphoric expectations with borrowers, or, on the other hand, the net worth of borrowers and the value of their collateral erode because of high interest rates. As a consequences, their relationship becomes strained, lenders may want to extend minimum credit or may even want to liquidate what they have already loaned, while debtors scramble for liquidity. Minsky calls this a financially fragile situation because borrowers become vulnerable to disruption of their economic activity.

III Conclusion

Islamic banking is based on two main financial principles. Firstly, investment is to be made in the private sector through interest-free financing. Secondly, the development of financial instruments is to be done on the basis of profit and loss sharing as well as sharing risks. Although the phenomenon of Islamic banking and finance has developed significantly in recent years, only very few studies have enquired into its efficiency and relevance in the wake of recent crisis in financial sector. Islamic banking in the west has often been regarded as a system having dislike for interest; however, it is something more than that as it also signifies as to amalgamation of ethics and economics so as to facilitate financial growth and economic welfare.

It is quite clear from the above discussion that interest based financing structure is the main factor causing financial ripples and leading to economic slowdown and financial crisis. Islamic finance in general, and Islamic banking in particular, could be the only solace in the present economic scenario as it can be used as an alternative system whose operations are based on interest free mechanism.

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