RAY: International Journal of Multidisciplinary Studies, E-ISSN: 2456-3064
Volume III, No. 1, April, 2018, pp. 1-11.

An analyses on the different Modes of Payment and the Problems faced by Islamic Banking

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Structured Abstract:

Purpose: The study points out the different ways and modes of payment in the Islamic financial institutions or Islamic banking. The study also shows that the problems faced by the Islamic banking which is one of the emerging financial institutions working as per the Islamic rules and law.

Design / Methodology / Approach: The study contains the secondary source of data which is collected from different books, journals, research papers.

Findings: The study shows that Islamic banking got different rules and regulation on their functioning of payments and their savings which work purely interest free. At the same time, it got many problems because it is not possible in every country to implement the rules which are followed by this banking system.

Originality / Value: The study shows that in this modern world where the financial sector of each and every country getting much importance and touching the highest of its success, at the same time Islamic banking also become emerging one. At least in fifty-one Muslim and non-Muslim countries got these banks which work separately from these modern banks.

Keywords: Investment, Banking, Islamic, Muslim, Payments.

Introduction

The Islamic banking or Islamic economics arises during the second half of the twentieth century as a usual consequence of the independence of some Islamic countries from domination. The existing Islamic banking become thirty-one-year-old, the number of Islamic banking increasing day bay day in whole world, both in Muslim and non-Muslim countries. These banks work interest free and have different modes of payment, at the same time this banking's work as interest free. Generally, all interest-free banks agree on the basic principles. However, individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks and Institutions etc.

Objectives

- To study about the different modes of transaction in Islamic banking
- To understand the current problems faced by the Islamic banking

Research Methodology

This analysis has based on the theoretical work, which covers several aspects of Islamic banking. The focus is only on the modes of payment in Islamic banking and its problems. Data for this research paper has been collected from secondary sources and different Islamic websites has also been used.

Literature Review

One key element of Islamic financial transactions is the value placed on trust and transparency between bank and customer. Contracts are designed to be straightforward so that each party involved in the transaction clearly understands what is being exchanged. As a result of this culture of transparency and the five pillars noted above, risk exposure is limited in both investing and lending. Proponents of Islamic finance assert that this banking model promotes financial stability both through its technical restrictions and its socially conscious orientation. (Asian Focus July 2009)[1]

The term "Islamic economics" occurs during the second half of the twentieth century as a natural result of the independence of some Islamic countries from colonialism. The contemporary practice of Islamic banking and finance is now 30 years old, the number of Islamic financial institutions worldwide has risen since the establishment of the monetary system and the Islamic banking does not need to wait to achieve the ideal Islamic society morally conscious, because Islamic financial products may not necessarily require a complete Islamic environment, but can be applied successfully even in non-Islamic countries. (Ruba Abu Shihab 2013)[2]

The rapid evolution of the domestic Islamic financial system has set the stage for its global integration. Now developmental efforts in Islamic finance have also been intensified to position Malaysia as an international Islamic financial hub that will have a greater role in facilitating international economic and financial flows. These efforts have been directed towards institutional development, enhancing the domestic financial infrastructure, strengthening the Shari'ahand legal infrastructure and promoting greater international integration. (Hafas Furqani 2009)[3]

Main Idea

The various forms emerged out of profit-loss sharing principle may be discussed as under:

- *Mudarabah*
- *Musharakah*
- *Ijarah*
- *Qaradul Hasanah and Sukuk*
- *Murabahah*
- *Muzara'ah and Mushaqat*

Mudarabah

Mudarabah is a special kind of partnership where one partner providers the capital (rabb-ul-maal) to the other (Mudarib) for investment in a commercial enterprise.

Types of Mudarabah

1. The rabb-ul-maal may specify a business in which to invest, in which case the Mudarib is restricted only to such business as pointed out by rabb-ul-maal. This is called restricted Mudarabah or al-Mudarabah al-muqayyadah.
2. If rabb-ul-maal has not specified a business in which to invest, it is considered an unrestricted Mudarabah or al-Mudarabah al-mutalaqah.

Musharakah

Musharakah is the word of Arabic origin which literally means sharing. *Musharakah* is a term frequently referred to in the context of Islamic modes of financing. The term *Musharakah* has been derived from the root term *Shirkah* which means sharing. The term *Musharakah* is not found in the books of *Fiqh*. This term (i.e., *Musharakah*) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of *Shirkah*, that is, the *Shirkat-al-amwal (Islamic banking October 04, 2006),* where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes *Shirkat-ul-a 'mal* also where partnership takes place in the business of services. So it is clear that the term *Shirkah* is a broader concept than the term *Musharakah*.

Ijarah

Ijarah lexically means "to give something on rent". In the Islamic jurisprudence, the term Ijarah is used for two different situations. In the first place, it means 'to employ the services of a person on wages given to him as a consideration for his hired services.' The employer is called Musta'jir while the employee is called Ajir.

The second type of Ijarah relates to the usufructs of assets and properties, and not to the services of human beings. Ijarah in this sense means 'to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.' In this case, the term Ijarah is analogous to the English term 'leasing'.

Qaradul Hasanah and Sukuk

There are some other modes of financing in Islam as well like Qaradul Hasanah i.e. Goodly Loan and Sukuk i.e. Islamic Bonds. This is a loan on goodwill basis and the debtor is only required to repay the amount borrowed. However, the debtor may, at his own discretion, pay an extra amount beyond the principal amount of the loan, without promising it as a token of thanks to the creditor. Some Muslims consider only this type of loan as permissible and the only type of loan that does not violate the rules of prohibition on interest but this is not so. The other modes of financing are also permissible rather preferred as they encourage the employment in the State.

The introduction of Sukuk in Islamic finance has been a great help. Many a project in private and public sectors have been facilitated by recourse to Sukuk. For example, an aircraft leased to an airline can be represented in bonds and owned by a number of Sukuk holders, each of them individually and independently collecting their periodic rent from the airline company. The Sukuk holders are not owners of a share in a company that owns the leased asset, but simply a sharing owner of a part of the aircraft itself. Islamic banks are also able to offer leasing certificates to their depositor clients as specific investment certificates as a form of declining equity. These mechanisms facilitate the formation of fixed assets and can contribute to long term economically beneficial investment. Sukuk have great potential for promoting risk sharing thereby increasing savings mobilization and investment, spurring growth leading to enhanced welfare. But at the same time, we should be aware of possible ways of keeping Sukuk away from being debt instruments based on risk shifting that increase inequality and cause instability, thereby decreasing welfare. The Islamic way of risk sharing, on which genuinely Islamic Sukuk should be based, would make the additional wealth created with the use of the existing wealth to be shared between fund users and fund owners while both bear the risks involved and the resulting loss.

Murabahah

Ruling about Murabahah: Buying by instalments is one of the issues where we should pay attention to finding out the rulings, because it has become very widespread in dealings on the individual and international level after the Second World War. So companies and corporations buy products from the suppliers by instalments, and they sell them to their customers by instalments, such as cars, real estate and tools, etc.

One of the things that led to this becoming widespread is the fact that some of the banks also deal in such transactions, whereby the bank buys the product with cash and sells it to its customers by instalments.

There is a text which states that it is permissible to buy by instalments, which means buying a product and delaying payment.

"Narrated from Aa'ishah (ra) that the Prophet (saw) bought some food from a Jew to be paid for later, and put an iron shield in pledge for it". ***(Al-Bukhaari H 2068 and Muslim H 1603)***

This hadeeth indicates that it is permissible to make a purchase with delayed payment, and buying by installments is nothing other than buying with delayed payment; all it means is that the price is divided into amounts, each of which must be paid at a certain time.

Muzara'ah and Mushaqat

Muzara'ah and Mushaqat are also forms of profit sharing. These modes of financing are directly related to land or accusation of land. Land has been an important factor of production since ancient times. In agrarian economies, it is still the most significant agent of production as most of the population depends on agriculture, fishers, dairies or allied activities. Most of the Muslim countries have an agrarian base and their economic wellbeing is a function of the proper utilisation of land. The agricultural development of a country depends on numerous factors majority of which are of a temporal character. Therefore, most of these matters have been left to the people of each age, except a few general instructions about the development of dead lands, peasant-landlord relationship, and the rights of the state to donate public lands to the individuals. Emphasis on the development of dead lands is indicative of the Prophet's (saw) interest in the utilisation of resources for the wellbeing of people.

Muzara'ah translated linguistically means crop-sharing. In Muzara'ah land is given by the owner to a farmer for cultivation for a given period. The harvest is shared in a pre-determined proportion between the owner and the cultivator. The sharing is usually in kind. The owner may provide seeds and fertilizers to the farmer for undertaking the cultivation. Mushaqat is like Musharakah applied to Horticulture and the like. There are several forms of Mushaqat. In one form of Mushaqat, two parties or several participate in financing an orchard as well as managing it and they share the yield. In another case of Mushaqat the owner of an orchard enters into an agreement with a party which is interested in acquiring the product of the orchard for the sale to earn a profit. The purchaser may offer a lump sum in advance of the sale to the owner or they may agree to share the profits of the sale in an agreed proportion. The transaction may relate to cutting down of the trees to be sold as timber. In this case one of the two parties can be an Islamic bank which either owns the land/orchard or holds it on behalf of a client.

Problems and challenges faced by Islamic banking:

This is the fact that the emergence and growth of the Islamic economic system is a phenomenon that has generated considerable interest in the financial world across the Globe. Why should not be so, as the Islamic economic system offers solution to the problems which were created by other –isms. But at the same time, we should remember; what could sustain Islamic Banking and finance till now can hardly be expected to guarantee its continued progress in the future. It is one thing to capture a large chunk of the market in our home base but it is completely a different task to attract customers in the global market place. Most of the Islamic Banks operate on Murabahah and Hire Purchase/Leasing mode of Investment I.e. Islamic Banks always prefer to run on mark-up/guaranteed profit basis having *Shari'ah* coverage. Islamic banks also operate on *Musharakah* and *Mudarabah* basis but this proportion is negligible as compared to other forms.For this reason,sometimes the conventional Economists and General people fail to understand the real difference between Islamic Banking and conventional Banking.

Mudarabah and *Musharakah* modes of Investment are ideal but Islamic Banks are not going in these two modes, for various problems they face. Mention may be made of few:

Unfamiliarity with the Islamic Banking System

The foremost and severe problem is that despite the growth of Islamic banks over the last 40 years, many people in the Muslim and non-Muslim world do not understand what Islamic banking actually is. The basic principle is clear, that it is contrary to Islamic law to make money out of money and that wealth should accumulate from trade and ownership of real assets. However, there does not appear to be a single definition of what is or not an Islamic-banking product. There is not a single definition of Islamic banking, rather any activity, any task or any method of banking fulfilling the criterion laid down by *Shari'ah* constitute the Islamic banking system. A major issue here is that it is the Shari'ah Councils or Boards at individual Islamic banks that actually define what is and what not Islamic banking is, and what is and what is not the acceptable way to do business, which in turn can complicate assessment of risk for both the bank and its customer. More generally, the uncertainty over what is, or is not, an Islamic product has so far prevented standardization. This is difficult for regulators as they like to know exactly what it is they are authorizing. It is also an added burden on the banks that they have to educate customers in new markets. They have also to educate the existing customers and new a well about the new methods and modes of financing through banks and also the new systems of banking business.

Lack of Systematic Analysis and Research

There is no systemic analysis and research and no real efforts to introduce above mentioned two modes so the practitioners (A practitioner is someone who is qualified or registered to practice a particular occupation, profession, or religion) blame the following factors: -

- There is lack of committed entrepreneur.
- There is lack of committed professional who can create new instruments.
- There is lack of committed sponsors who can pressurize the professionals.
- There is shortage of skilled professionals.

Bankers due to the nature of their job have to be pragmatic and application-oriented.

There is and will be need for the bankers practicing in Islamic banks to mould or modify the prevailing practices in accordance with *Shari'ah* to suit the requirement for transactions at hand. However, being immersed in the travails of day to day banking, they find little time and inclination to do any research work, which can make substantial contribution to the Islamic banking. On the other hand, Islamic scholars active in researching Islamic banking and finance, typically have normative approach. A very few of them are knowledgeable about modern banking system or the needs of the customers.

Problems related to legal Authority

The absence of *Shari'ah-compliant* legal framework is major trouble which the Islamic banking system in particular and Islamic economic system in general in facing. The present-day conventional banking laws prohibit banks to engage directly in business activities using depositors' funds. On the other hand, this is the base on which Islamic banks and banking methods are built. So, new legislation becomes inevitable. In this Iran has passed a comprehensive legislation to establish Islamic banks, followed by Pakistan, Malaysia and few other countries. But if Islamic banking system has to flourish this should be done worldwide. Islamic law offer its own frame works for execution of commercial and financial contracts and transactions. The commercial and banking laws appropriate for implementation of Islamic banking and financial contracts do not exist. On the contrary the present day conventional banking laws contain provisions that are narrowly defined and thus prohibit the scope of Islamic banking activities within conventional limits. If there are disputes to be handled, present banking laws are not sufficiently acquainted with the rationale of the operations of Islamic banking. In non-Muslim countries, the central banks are very stringent in granting licences for Islamic banks to operate. In order to establish an Islamic bank in a non-Muslim country, it must also meet the additional requirements of the governmental as well as non-governmental authorities. Thus apart from legal constraints, there are economic constraints, political constraints and the like. With this respect, the best example can be The Islamic Bank in Kerala. The problems it suffered for its establishment are many in number.

Investment Management

The problem which lays with regard to investment management boils down to risk management in modern times and regrettably the risk management is still under developed in Islamic financial theory and practice. In addition to this fact, in Islamic perception, it is one of the areas of conventional finance which is in need of drastic reforms. So, this actually represents a double challenge-to develop Islamic techniques of risk management and to see that these new techniques are free from ills with which conventional methods are suffering.

Lack of Professionalism

The need for professional bankers and managers for Islamic banks cannot be ignored. Various Islamic banks are run by direct involvement of the owner himself, or by those managers who have not much exposure to Islamic banking activities, nor are they familiar with conventional banking methods. Consequently, many Islamic banks are not able to face challenges and stiff competition. There is a need to institute professionalism in banking practice to enhance management capacity by competent bankers committed to their profession. This gives rise to a need for banking professionals to be properly trained in Islamic banking and finance. This training in itself is hindered by hurdles. Firstly, it is a time consuming process, which is aggravated by two other factors. One the number of persons that need to be retrained and second the additional staff that needs to be recruited and trained to carry out the increased work load. Principles are still to be laid down and techniques and procedures are still to be evolved. It is only after the satisfactory achievement of these principles so that proper training can begin. This delay and the resulting confusion appears to be among the main reasons for the banks to stick to modes of financing that are not ideal from Islamic perspective.

Nonexistence of Islamic Money Markets

Regarding constraints, absence of Islamic money market is one of the intense problems. The activities of the Islamic banks as a consequence are not demand oriented and do not reflect flexibility to structural shifts in the economic setting as well as to changes in preferences of the depositors. It is known to the bank management that a certain portion of the short-term deposits is normally not withdrawn at maturity; so these funds can be used for medium and in some cases long-term financing. However, a precondition for this usage is that the bank must be able to obtain liquidity from external sources in case of unexpected withdrawals and emergencies. In the absence of Islamic money markets, the Islamic banks cannot invest their surplus funds i.e., temporary excess liquidity to earn any income rather than keeping it idle. In present times the government treasury bills, approved securities or other bonds and certificates are interest bearing. With the result, the Islamic banks cannot invest the permissible excess part of their reserves to earn income.

Shortage of Supportive Institutions

Islamic banking like any other system, however well-established it may be, cannot flourish exclusively on its built-in elements. It has to depend on a number of supportive and link-institutions. For identifying suitable projects, Islamic banking need to use services of economists, lawyers, management consultants, auditors, other financial and insurance companies compatible with *Shari'ah*. They also need research and training forums in order to develop entrepreneurship skills among their clients. Such supportive services properly oriented towards Islamic banking are yet to be devised.

Conclusion

In this modern world where the financial sector of each and every country getting much importance and touching the highest of its success, at the same time Islamic banking also become emerging one. At least in fifty-one Muslim and non-Muslim countries got these banks which work separately from these modern banks. Islamic banking got different rules and regulation on their functioning of payments and their savings which work purely interest free. At the same time, it got much problems because it is not possible in every country to implement the rules which are followed by this banking system.

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