The Basic Principles of Islamic Financial Institutions: Compared to Conventional Ones

- Islamic financial institutions have an important role to play in the light of Islamic teachings in order to please Allah (SWT).The fundamental principle of Islam states that the separation between temporal and religious matters is not permitted, which implies the compliance with Sharia'a as the basis for all aspects of life. This compliance covers not only religious worship but also business practices.
- Based on this, Islamic financial institutions revolve around several well established concepts based on Islamic Sharia'a. Islamic financial institutions must operate within the framework of the religion, based on Quran and Sunna. Hence their activity, transactions and behavior must be in line with these principles. The basic principles that that Islamic financial institutions must follow are:

1. **Business Framework**

   Islamic Banking System is based on Sharia'a laws - Sharia'a scholars ensure adherence to Islamic laws and provide guidance. While the conventional financial system is based only on man-made laws and no religious laws or guidelines

2. Interest (Riba)

Riba (Interest) in Islam is forbidden. Hence, all banking activities must avoid interest. Instead of interest, the Bank earns profit (mark-up) and fees on financing facilities it extends to customers. Also, depositors earn a share of the Bank's profit as opposed to interest.

Within Islamic financial institutions, it is not allowed to charge for the mere use of money. Whereas conventional financial institutions "trade" in money (buying money from depositors and selling money in the form of loans), Islamic financial institutions must "trade" in real assets or services. Most of the activities of the conventional financial institutions are interest-based financing.

3. **Prohibited activities / commodities**

   Sharia'a prohibits using or dealing in certain commodities or activities. Islamic financial system must encourage and develop the application of Islamic principles and law (Sharia'a) to transactions of finance, banking and business affairs. It controls the engagement of investment companies in activities that are tolerable and consistent with the Sharia'a law thus preventing the occurrence of activities forbidden by Islam. Only halal activities are allowed. Islamic financing will, therefore, be inappropriate in financing any enterprise involved in any type of activities/commodities that is unlawful in Islam or harmful to mankind. The Islamic Bank, for example, does not finance liquor manufacturing, transportation, storage or distribution companies. Sharia'a scholars screen the suitability of investments on an ongoing basis and provide guidance on products to the Bank's management.

3. **Uncertainty (Gharar)**

   Any contract based on a future uncertain event, within Islamic banking, is not generally allowable, e.g. hedging, dealing in derivatives, etc. Conventional financial system allows trading and dealing in derivatives of various forms is allowed.

4. **Contractual Relationship**

   Contractual relationship in Islamic financial institution depends upon the nature of transaction. It could be a seller-buyer relationship (Murabaha), a lessor-lessee relationship (Ijara), a partnership (Musharaka), or a creditor-debtor relationship (Qard Hassan). This relationship has only one form in the conventional financial institution which is only a creditor-debtor relationship.

5. **Participation and risk sharing**

   Another principle of Islamic finance is based on partnership and the sharing of risks. Islamic financial institutions offer investors/depositors participation in risk sharing type packages rather than fixed interest on deposits. Any risk-bearing instruments reflecting a real asset and earning a variable rate of return tied to the performance of the asset is considered to be consistent with Islamic law. In contrast to conventional banking principles what is condemned in Islamic banking is the notion of a risk free reward or return. The Islamic Financial system employs the concept of participation in the enterprise, utilizing the funds at risk on a profit-and-loss sharing basis, thus encouraging better resource management. Management of the enterprise can be in one of several forms depending on whether the financing is through Mudarabah, Musharaka, etc. The relation of investors to the institution is that of partners whereas that of conventional banking is that of creditor-investor. The Islamic financial system is based on equity whereas the conventional banking system is loan based.

6. **The Islamic ethics and behavior**

   The Islamic financial institution and its staff must behave and act within the framework of Islamic teachings in its broadest sense so that any person approaching an Islamic institution should be given the impression that he is entering a distinguished place not only in the types and quality of its products but in the way the customer is treated-with care, respect and the eagerness to help him and facilitate his matter.

7. **Contributes to the socio-economic goals of the Islamic society**

   The Islamic financial system should contribute to achieving the major socio-economic goals of the Islamic society. While conventional finance focuses solely on economic transactions and markets, Islamic financial system stresses the ethical, social and moral dimensions of wealth creation that enhance equality and fairness for the society as a whole.

   Islamic financial institution is socially responsible towards the poor, and needy in the Islamic society, and must contribute in the efforts of poverty alleviation and people empowerment through creating social funds for poor and needy and providing education scholarships to students. The Islamic bank is required to remind his customers of Zakat payments on the clients' assets which have not been used throughout the period of one year.

8. **Accounting Standards**

   Islamic financial institution abides by the accounting standards of Accounting and Auditing Organization for Islamic Financial Institutions "AAOIFI" formed in 1988 in Bahrain. While conventional financial institution follows the accounting standards of the British Accounting Practices, American Financial accounting Standards and International Accounting Standards.

9. Balance Sheet

An Islamic financial institution serving as intermediary may act as partner or as a provider of services in profit-making ventures. Because of the joint participation among an Islamic financial Institution, shareholders and depositors in equity investment, the structure of the balance sheet of an Islamic financial Institution may differ from that of a standards conventional depository institution because the equity capital base of Islamic financial institution may be larger than that of a conventional depository institution. The balance sheet of Islamic Banks will not show the interest earning assets and Interest bearing liabilities. Also, the balance sheet of the Islamic Banks will be more detailed than of the Conventional banks such as will include: Investments in Murabaha, Istina'a…etc. versus Loans and Advances.

10. Sharia'a Supervisory Board (SSB)

Islamic banks are supervised by a Sharia'a Supervisory Board (SSB) which allows the bank to conduct its financial transactions in accordance with Sharia'a. The transaction structured and supporting documentation approved by a Sharia'a Supervisory Board and for the transaction Offering Document to include a copy of their "FATWA". This Board will generally be comprised of three or more of scholars who are well versed in Islamic jurisprudence. There is no existence of such Board in the conventional bank which aiming to attain profit without considering Sharia'a precepts.