Effect of the financial crisis on islamic banks

Finance, Banks

Islamic banking is a very young concept even though it has already been implemented as the only system in two Muslim countries; there are Islamic banks in many Muslim countries, and a few in non-Muslim countries as well. Despite the successful acceptance there are problems. These problems are mainly in the area of financing.

Dubai Islamic Bank was the first private interest free bank and was set up by a group of Muslim business men from different countries in 1975. in 1977 two more private banks under the name of Faisal Islamic bank were founded in Sudan and Egypt. Since the establishment of the Dubai Islamic Bank, more than 50 interest free banks have been set up. Most of them are in Muslim countries but there are others in Western Europe as well as Denmark, UK, and also Switzerland.

All the interest free banks use basic principles that are agreed upon but individual banks have different ways of implementing and applying the principles. These differences are brought about by a countries laws, the circumstances facing the bank, its objectives and experience as well as its interaction with other banks.

The features of the Islamic banks

The interest free banks have three kinds of deposits, namely; current accounts, savings accounts and investment accounts. The current accounts operate just like the other conventional banks.

In the savings accounts are treated differently depending on the banks policies. In some cases, the banks are allowed to use the clients money but they have to guarantee to give back full the full amount. In this cases, no capital is promised. On the other hand, savings accounts are treated as if they were investment accounts but they have less stringent withdrawal and minimum balance conditions. In these cases the expected profits level are usually low and only a portion of the average minimum balance is awarded.

With the investment accounts, deposits are accepted for a given period of time and the investors make an agreement in advance on how the profits will be shared with the banks. For this accounts, a capital is not guaranteed.

MODES OF FINANCING

The mode of financing in the Islamic banks is carried out in three ways; investment financing, trade financing, and also lending.

Investment financing has three perspectives; musharaka, mudharaba and estimated rates on return basis investment. In mushraka, the bank joins another bank to set up a joint venture with both parties participating in their different activities. The profit or loss made from the venture business is shares among the banks in accordance to a pre arranged agreement. This venture is usually an independent legal entity and the bank has the right to gradually withdraw after the initial period.

In mudarabha, a bank contributes finances required for an investment and the client sources and provides the needed expertise, labor as well as the management to oversee things. The profit gained from these investment is shared between the bank and the client according to a pre arranged plan. Incase losses are made, the bank takes responsibility.

Financing on the basis of an estimated rate of return. The bank makes an estimation of the expected rate of returns on an investment on project that it has been requested by a client to finance. The bank then provides the financing on the condition that the rate is payable to the bank in a given time period or intervals. Incase the expected rate on return is higher than the estimated rate, the client takes the excess profits but if it is less than the estimated rate, the bank accepts the lower rates. In case of a loss, the bank shares in it.

Trade financing

Trade financing is also carried out in several ways; mark up, leasing, hire purchase, sell an buy back, and letters of credit. In the mark up approach, the bank buys an asset for the client and is to be paid at a certain time for a certain price and some profit. In leasing, the bank simply purchase an item and leases to a client for an agreed time. At the end of this time period, the client pays the balance and becomes the owner of the item. Hire purchase is similar to leasing only that the item purchased by the bank is hired to the client for a given period and when the ends, the client automatically becomes the owner if the item.

The buy and sell back approach entails a client selling an asset to the bank at a price payable immediately and promises to buy it back from the bank after an agreed time period and for a pre determined price. Letters of credit involves international trade. In this case, the bank uses its funds to guarantee the import of an item in place of the client, on condition that the profits made from the sale of the item will be shared between the bank and the client.

LENDING

The third mode of financing used in the Islamic banks is lending and it has three forms namely; loans with service charge, no cost loans and bank overdrafts. Loans with service charge are loans that are given to the clients with no interest but a service charge is levied to cover the expenses incurred by the bank during the transaction. No cost loans are loans offered by the bank and no interest or service charge is required. The bank is required to set aside funds to enable it to grant these loans that are aimed at helping the needy people and also the small businesses. Bank overdrafts are also allowed in the Islamic banks and free of charge but they are subject to a certain maximum.

Other services offered by the Islamic banks are; money transfers, bill collections as well as foreign currency trade which is at a spot rate. Islamic bankers treat their depositors as partners, in the sense that they have invested their money in the bank and the profits and losses should be shared accordingly

The effects of financial crisis on Islamic banking

Islamic banks looks at the sharia law for guidance in its activities and bans interest gaining activities and trading debt. Islamic finance is being promoted as way of dealing with the financial crises that is global. This year is said to be a mile stone for Islamic banking in the sense that the global financial crises has provided the Islamic banking with a golden opportunity globally re establish itself as a main stream and a financier and provider for equity and debt. The main reason as to why Islamic financing is said to be a good remedy for the current market is the fact that one can only promise what they have.

For the first time, Islamic banking has been considered as a choice among the present structures and the current systems in reference to products and solutions to the financial crisis. It is therefore important for nations to adopt the Islamic banking techniques and principles in running their economies.

Islamic banking industry is facing challenges and most of these challenges are in real estate and stock prices, according to advocates the system has built-in protection from the kind of runaway collapse that has afflicted so many institutions. The use of financial instruments like derivatives, which are said to contribute highly to the down fall of banks, insurance and investment giants, is banned.

The dealing of Islamic banks is directly linked to economic activities that involve assets or the provision of services. This banking system is also distinguished from other financial systems fo it commitment in upholding integrity and its way of avoiding risky business activities. The reason as to why this global financial crises has greatly affected other banks especially the world bank is their involvement in debt buying and accounts enlargement without evident or tangible transactions being carried out.
The fact that the Islamic banking has been the least affected by the financial crisis has made it more attractive. Islamic Banking portrays many new and unique ideas that present the Islamic Banking system as a way of ensuring full employment, equitability of wealth, prices stability, income distribution, and sustained growth. The Islamic bank also carries out investigations on the

nature and functions of money in interest free banking system and then, integrates money in capital theory.

The lack of debt in the Islamic financial systems has saved it from many financial problems that are brought about by bad credit and this has seen its survival through rough financial periods. Also its prohibition of a risk free interest on return and trading permission has made the financial activities in an Islamic financial set up to be real estate backed and this gives it the ability to bring about value addition.

The success of the Islamic banking regardless of the global financial crises is attributed to its capitalist financial system. The reason as to why Islamic banks have remained immune to the mortgage problem acing the international finance systems is because of their inherent factors. These factors include ; taking precautionary measures against money laundering, prohibiting trading in debt and also the professional and official restraints on taking up risky projects.

There were complains that the Islamic banks were not offering genuine Islamic banking products they offered products similar to those in other commercial banks and gave them an Islamic name with the aim of attracting commercial banks customers who did not want to pay interests. The effects of the global financial crisis on the Islamic banks was not known since the Islamic banks received a lot of support from many other governments. Instead, the Islamic banks have taken precautionary measures and diversified their economic activities so as to avoid the financial crises consequences.

It is argued that the global crises might continue for the next two years but the Islamic banks have secured liquidity which places it at a better position in facing the financial crisis in comparison to other financial systems. This success has led to serious considerations of using Islamic banking principles as it has continued to realize more achievements and has proved to be resilient an d viable to the currently crisis hit financial system