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Financing Principles in Islamic Banking

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ABSTRACT

The article notes that Islamic banking is the main developing part of banking sector around the globe. Nowadays, the number of banks working in Islamic principles is rising and their benefit also is higher than the traditional ones according to some statistics. Interest (Riba) is confirmed as haram by Sharia, so they possess sharia-compliant activities. This article reveals the essence of the category of "islamic financing", shows the ways how to finance the corporate clients and individuals, analyses the procedure and advantages of using Islamic principles than credits in banking sector. And what deserves attention is that the article formulates a number of characteristics, on the basis of which the author's own version of the definition of the category "Islamic financing" has been developed.

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Introduction. Islamic banking, also referred to as Islamic finance or shariah-compliant finance, refers to financial activities that adhere to shariah (Islamic law). Two fundamental principles of Islamic banking are the sharing of profit and loss, and the prohibition of the collection and payment of interest by lenders and investors.

There are approximately 520 banks and 1700 mutual funds around the world that comply with Islamic

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principles.[1] Between 2012 and 2019, islamic financial assets grew from $1.7 trillion to $2.8 trillion and are projected to grow to nearly $3.7 trillion by 2024, according to a 2020 report by the Islamic Corporation for the Development of Private Sector (ICD) and Refinitiv.[2] This growth is largely due to

the rising economies of Muslim countries (especially those that have benefited from the increases in the price of oil).

Literature review and methodology. To earn money without the typical practice of charging interest, Islamic banks use equity participation systems. Equity participation means if a bank loans money to a business, the business will pay back the loan without interest, but instead gives the bank a share in its profits. If the business defaults or does not earn a profit, then the bank also does not benefit. In general, Islamic banking institutions tend to be more risk-averse in their investment practices. As a result, they typically avoid business that could be associated with economic bubbles.

To facilitate access to credit, Islamic finance is based first of all on raising the awareness of individuals with the capacity to finance their responsibility towards Allah, in relation to the wealth of which they are the depositaries. Riba is a concept in Islamic banking that refers to accrued interest. This is also called usury, or charging unreasonably high interest rates. There is also another form of riba, according to most Islamic jurists, which refers to the simultaneous exchange of goods of unequal quantity or quality. Here, however, we will have in mind the practice of calculating interest.[3]

Riba is prohibited by Sharia law for several reasons. The Quran proclaims the prohibition of Riba and encourages believers to abstain from it. This shows that this practice existed during the time of Prophet Muhammad.

A common practice in the business community of old times, when the borrower or the buyer on credit had difficulties in repaying its debt, was to double the maturity period of the principal due, but at the cost of doubling the interest rate. This way of doing things is called Riba al-jahïliya, or Riba (of the period) of ignorance, in reference to the pre-Islamic era. There is no credit term in the Islamic banking system. Instead, there are sources of Islamic financing.[4]Lending to corporate clients is based on the principles of muzaraba, mushoraka, murobaha, bai muajjal and ijara. Banks provide special financing to individuals for the purchase of housing, buildings, consumer goods and more. This financing is based on the principle of bay muajjal and qarzi hasan.

Discussion. *Muzaraba* contracts are used to transfer funds to a trustee (entrepreneur, businessman) to conduct business from an investor. The investor does not interfere in the process of doing business and at the end of the agreed period the entrepreneur returns to the investor the amount of the principal investment and its share of profits.

Musharaka is a joint enterprise or partnership structure in Islamic finance in which partners share in the profits and losses of an enterprise. Since Islamic law (Sharia) does not permit profiting from interest in lending, musharakah allows for the financier of a project or company to achieve a return in the form of a portion of the actual profits according to a predetermined ratio. However, unlike a traditional creditor, the financier also will share in any losses should they occur. Musharakah is a type of shirkah al-amwal (or partnership), which in Arabic means "sharing." Within musharakah, there are differing partnership

[1] Islamic Corporation for the Development of the Private Sector. "Islamic Finance Development Report 2020, Page 2. Accessed Oct. 26, 2021

[2] Islamic Corporation for the Development of the Private Sector. "Islamic Finance Development Report 2020, Page 8. Accessed Oct. 26, 2021

[3] https://www.Investopedia.com

[4] https://www.scirp.org/journal/paperinformation

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arrangements.

- In a shirkah al-'inan partnership, the partners are simply the agent and do not serve as guarantors of other partners. Shirkah al-mufawadah is an equal, unlimited, and unrestricted partnership in which all partners put in the same sum, share the same profit, and have the same rights.
- A permanent musharakah has no specific end date and continues until partners decide to dissolve it. As such, it is often used for long-term financing needs. A diminishing musharakah can have a few different structures.
- In a diminishing partnership (also known as a declining balance partnership or declining musharakah), one partner's share is drawn down while it is transferred to another partner until the entire sum is passed over. Such a structure is common in home-buying where the lender (generally a bank) buys a property and receives payment from a buyer (via monthly rent payments) until the whole balance is paid off.

Murabaha, also referred to as cost-plus financing, is an Islamic financing structure in which the seller and buyer agree to the cost and markup of an asset. The markup takes place of interest, which is illegal in Islamic law. In a murabaha contract of sale, a client petitions a bank to purchase an item on the behalf. Complying with the client's request, the bank establishes a contract setting the cost and profit for the item, with repayment typically in installments. The murabaha form of financing is typically used in places of loans in deverse sectors. For example, consumers use murabaha when purchasing household appliances, cars, or real estate. Businesses use this type of financing when purchasing machinery, equipment, or raw materials. A murabaha letter of credit is issued on behalf of an applicant (importer). The bank issuing the letter of credit agrees to pay an amount of money in compliance with the terms described in the letter of credit. Because the bank's creditworthiness replaces that of the applicant, the beneficiary (exporter) is guaranteed payment. This benefits the exporter because the bank assumes the payment risk. Following the murabaha contract provisions, the importer is required to repay the bank for the cost of goods plus a profit markup amount.

In Islamic financing profit-sharing modes cannot guarantee banks income. Murabaha, with its fixed margin, offers the seller a more predictable income stream. One estimate is that 80% of Islamic lending is by murabaha. As of 2005,"the average cost efficiency" for murabaha was 74%, whereas average profit Efficiency even higher at 84%. Islamic banker and author Harris Irfan writes hat use of murabaha has become so distorted from its original intent that it has become the single most common method of funding inter-bank liquidity and corporate loans in the Islamic finance industry. *Bai muajjal* may be defined as sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments. This system could be of considerable use in financing current input requirements of industry and agriculture as well as in the financing of domestic and import trade. For instance, if the current cost of a bag or fertilizer to the bank is 50 dollars, the bank may sell it through its agent to farmers needing bank finance at 55 dollars to actual payment of this price after an agreed period. The bank would, however, pay 50 dollars to its agent prior to or immediately after the supply of the fertilizer by the agent under its instructions. The possible mechanism in the case of domestic and import trade may be in the following pattern: A business firm needs finance from a bank to purchase an item from a domestic seller or foreign exporter. Instead of discounting a bill or making an advance, the bank under an agreement with the firm concerned may purchase the commodity on its own account and sell it to the firm at a price, to be settled in advance, which includes a mark-up over the cost price for a reasonable profit margin for the bank. Payment from the firm would be receivable by the bank after the agreed period.

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Qard al-Hasan is the one which the borrower repays the principal amount of the loan without interest, mark-up, or a share in the business for which the loan was used.

Conclusion and recommendation. Islamic finance offers lots of advantages than the traditional ones. Firstly, it helps by assisting financial inclusion. Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs-transactions, payments, savings, credit and insurance-delivered in a responsible and sustainable way. Secondly, it reduces the impact of harmful poducts and practices, suggests financial justice, encourages stability in investments and accelerates economic development.

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