

Islamic Banking

Paul A. Adekunle¹, Matthew N. O. Sadiku², Janet O. Sadiku³

¹International Institute of Professional Security, Lagos, Nigeria

²Roy G. Perry College of Engineering, Prairie View A&M University, Prairie View, TX, USA

³Juliana King University, Houston, TX, USA

ABSTRACT

Islamic banking is a financial system founded on the principles of Sharia (Islamic law), with emphasis on ethical conduct, social justice, and the linkage of finance to real economic activity. Islamic banking unlike the conventional banking prohibits the payment or receipt of interest (riba), excessive uncertainty (gharar), and speculative activities (maisir), while promoting profit-and-loss sharing cum asset-backed transactions. Its core financing mechanisms such as *Murabaha* (cost-plus sale), *Mudarabah* (profit-sharing partnership), *Musharakah* (joint venture), and *Ijarah* (leasing) enable Islamic banks to provide financial services that are both commercially viable and compliant with religious principles. In order to maintain compliance, governance is ensured through Sharia supervisory boards, which oversee product design and operations. Regardless of the challenges related to standardization, liquidity management, and regulatory harmonization, Islamic banking has continued to expand across both Muslim-majority and non-Muslim countries, offering an alternative model of finance that integrates economic efficiency with moral and social responsibility. This paper attempts to holistically look at the challenges facing Islamic banking, solutions to them, and its benefits to humanity.

KEYWORDS: *Islamic banking, Sharia (Islamic law), Islamic commercial jurisprudence (Fiqh al-Mu'amalat), social responsibility, riba (usury or interest), zakat, equity and justice.*

INTRODUCTION

As a financial system, Islamic banking operates in accordance with Sharia (Islamic law) – emphasizing ethical investment, fairness, and transactions tied to real economic activity, as shown in Figures 1 and 2. It tends to avoid interest (*riba*), excessive uncertainty (*gharar*), and unethical business activities. This is Sharia-compliant financial system which adheres to Sharia (Islamic law) and its practical application via Islamic economics [1]. Islamic finance as a modern institutional system emerged fully in the mid-20th century and expanded globally, now overseeing a large and growing part of global finance – which is aimed at fostering a just society. It is not much different from the products and services in the traditional financial system but its operations are essentially based on a certain set of moral and ethical principles that determined what is viewed as morally ‘right’ implying actions and transactions that promote public good, and ‘wrong’ implying actions and

transactions likely to be against the public good. Furthermore, the Islamic financial system is not limited to banking but also covers insurance, capital formation, capital markets, and all types of financial intermediation and suggests that moral and ethical aspects in the regulatory framework are also necessary in addition to prudent and sound controls. The objectives (*maqsid*) of Islamic finance transactions are as stated below:

- To be true to the Shari’ah principles of equity and justice;
- Should be free from unjust enrichment;
- Must be based on true consent of all parties;
- Must be an integral part of a real trade or economic activity such as a sale, lease, manufacture or partnership [2].

HISTORICAL BACKGROUND

Islamic banking is deeply rooted in classical Islamic commercial jurisprudence (*Fiqh al-Mu'amalat*) which

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developed during the early centuries of Islam and provided detailed rules governing trade, contracts, money, and financial ethics. Even though modern Islamic banking institutions are relatively recent, their underlying principles date back more than fourteen centuries.

1. Early Islamic Period (7th-10th Century)

Economic transactions during the time of Muhammad and the early Islamic caliphates were governed by Sharia principles with emphasis on justice, fairness, and social responsibility. Trade, partnerships, leasing, and profit-sharing arrangements were widely practiced. Some of the common financial contracts included:

- Mudarabah (profit-sharing partnership),
- Musharakah (joint venture),
- Murabaha (cost-plus sale),
- Qard Hasan (benevolent loan).

Money during this period was treated primarily as a medium of exchange, not a commodity to generate profit through interest. The prohibition of *riba* (usury or interest) was clearly established in the Qur'an and reinforced by Hadith literature [3,4], as shown in Figure 3.

2. Medieval Islamic Trade and Finance (10th-15th Century)

Between the 10th and 15th centuries, Islamic civilization developed sophisticated commercial and financial practices that supported long-distance trade across the Middle East, North Africa, Asia, and Europe.

The following instruments were widely used and which later influenced European commercial banking practices i. e.,

- Sakk (early form of cheque),
- Hawala (informal value transfer system),
- Trade credit and partnerships.

Despite this sophistication, financial activities remained non-interest-based, relying on trade and risk-sharing arrangements [5, 6].

3. Decline and Impact of Colonialism (16th-19th Century)

The decline of Islamic empires coupled with the expansion of European colonial powers, Western banking systems based on interest gradually replaced traditional Islamic financial practices in Muslim regions.

Conventional banks were introduced to:

- Facilitate colonial trade,
- Finance government activities,
- Integrate colonies into the global capitalist system.

Due to this, Islamic financial principles were largely confined to personal ethics and informal practices, which led to no formal Islamic banking institutions operating during this period [7, 8].

4. Revival of Islamic Banking (Mid-20th Century)

The modern revival of Islamic banking began in the 1940s-1960s, which was driven by:

- Islamic economic thought,
- Post-colonial identity movements,
- Demand for financial systems aligned with religious values.

Some of the key milestones for achieving this include:

- Mit Ghamr Savings Bank (Egypt, 1963) – This was widely regarded as the first modern Islamic bank, founded by Ahmad El-Najjar.
- Pilgrims Management and Fund Board (Tabung Haji, Malaysia, 1963) – It enabled Muslims to save for Hajj without interest.
- Dubai Islamic Bank (1975) – The first private, full-fledged Islamic commercial bank [9, 10].

5. Institutionalization and Global Expansion (1970s-1990s)

From the 1970s onward, Islamic banking became institutionalized with the establishment of:

- Islamic Development Bank (IDB) in 1975,
- National Islamic banks in Sudan, Iran, and the Gulf States,
- Dual banking systems in Malaysia and other countries.

During this period, Sharia governance framework and standardized contracts began to emerge [11, 12].

6. Contemporary Era (2000s-Present)

In the 21st century, Islamic banking has evolved into a global financial industry, operating in both Muslim-majority and non-Muslim countries. Credibility and harmonization have been enhanced via the establishment of international standard-setting bodies. Some of the key institutions include:

- AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions),
- IFSB (Islamic Financial Services Board),

Islamic banking now encompasses retail banking, corporate finance, capital markets (*sukuk*), and risk management (*takaful*) [13-15].

CORE PRINCIPLES OF ISLAMIC BANKING

The core principles of Islamic banking are derived from Sharia law, with emphasis on fairness, transparency, and social justice. Some of these key principles include [1, 2, 16-20]:

- Prohibition of Riba (interest) – no interest or usury is allowed; money isn't used to generate more money through interest.

- Risk-sharing (Profit-and-Loss Sharing) – parties share both profits and losses, hence promoting fairness and cooperation, as shown in Figure 4.
 - Tangible assets (Asset-Backed and Real Economic Activity) – Transactions must be backed by real assets, reducing speculation.
 - Sharia Compliance and Supervision – Islamic banks under the guidance of Sharia law, with activities/operations reviewed or supervised by a Sharia Supervisory Board (SSB) composed of Islamic scholars.
 - Gharar (excessive uncertainty) prohibition – Minimizes excessive speculation or uncertainty in speculations.
 - Maysir (gambling) prohibition – No gambling or speculative activities allowed.
 - Halal activities only – Financing must comply with Islamic ethical standards.
 - Money as a medium of exchange - not a commodity or tradable asset that can generate profit on its own.
 - Ethical and Social Responsibility – Islamic banking is to promote social justice, fairness, and moral conduct. Financing of activities that harm society, such as alcohol, gambling, pornography, and weapons of mass destruction is prohibited.
8. *Qard Hasan* (Benevolent loan) – This is interest-free loan provided for welfare or short-term needs. The borrower repays only the principal [20, 23].
 9. *Zakat and Waqf-based* financing – Islamic banks may manage or distribute zakat and waqf funds, as shown in Figure 6. This is to support poverty alleviation and social development [19, 24].
 10. Islamic Investment Funds – These are equity, real estate, or commodity funds screened for Shari'ah compliance [15, 19].
11. Deposit Products:
- A. Current accounts – operate on Qard basis; deposits are guaranteed but earn no return.
 - B. Savings and investment Accounts – Based on Mudarabah, while returns depend on actual profits [17, 18].

BENEFITS

Some of the derivable benefits include the:

1. Promotion of social justice and fairness
2. Encourages risk-sharing and cooperation
3. Supports real economic activity
4. Provides an alternative to conventional banking

CHALLENGES FACING ISLAMIC BANKING

Some of the challenges faced by Islamic banking include the following:

POPULAR ISLAMIC BANKING PRODUCTS

Some of the products of Islamic banking include [16, 21, 22], as shown in Figure 5:

1. *Murabaha*: This is cost-plus financing, where the bank buys an asset and sells it to the customer at a markup
2. *Musharaka*: This is partnership financing, where the bank and customer share profits and losses.
3. *Ijara*: Leasing, where the bank leases an asset to the customer for a fee.
4. *Sukuk*: These are Islamic bonds, representing ownership in a tangible asset. Investors earn returns from underlying assets, not interest.
5. *Salam* (forward purchase) – In this case, full payment is made in advance for goods delivered in the future. It is common in agricultural financing [17, 20].
6. *Istisna* (manufacturing contract) – It involves financing for assets to be manufactured or constructed. Used in infrastructure and industrial projects [12, 13].
7. *Ijarah wa Iqtina* (lease-to-own) – This combines leasing with gradual or eventual transfer of

1. Standardization of Sharia interpretation: Different interpretations of Sharia law can lead to inconsistencies [25]
2. Regulatory frameworks: Islamic banks often operate in conventional regulatory environments, creating compliance issues [14]
3. Global integration: Integrating Islamic finance into global markets requires harmonization [16, 21, 26]
4. Liquidity Management: There is also the challenges of managing liquidity due to limited instruments [27]
5. Product Innovation: Limited innovation in Sharia-compliant products can hinder competitiveness [28]

SOLUTIONS TO CHALLENGES IN ISLAMIC BANKING

Some of solutions facing Islamic banking are as follows [1, 13]:

1. Standardization of Sharia interpretation: This can be achieved by the establishment of global Sharia standards via bodies like the Accounting and

Audit Organization for Islamic Financial Institutions (AAOIFI).

2. Regulatory frameworks: Strengthen regulatory bodies and collaboration between central banks and Sharia scholars.
3. Product innovation: Need to develop innovative Sharia-compliant products to enhance competitiveness.
4. Capacity building: This is to enhance skills of Islamic banking professionals through training and education.
5. Global integration: To foster international cooperation and harmonization of Islamic finance standards.

CONCLUSION

Islamic banking represents a value-based financial system that integrates ethical considerations with economic objectives through strict adherence to Shar'ah (Islamic law). Islamic banking promotes risk-sharing, asset-backed financing, and real economic activity through the prohibition of interest (riba), excessive uncertainty (gharar), and speculative activities (maysir). The core contracts of Islamic banking, such as *Murabahah*, *Musharakah*, *Mudarabah*, *Ijarah*, and *Sukuk*, offer viable alternatives to conventional interest-based finance while emphasizing fairness, transparency, and social justice. For the past decades, Islamic banking has evolved from a niche concept into a globally recognized segment of the financial industry, contributing to financial inclusion, stability, and sustainable development, particularly in Muslim-majority countries and increasingly in non-Muslim jurisdictions. Furthermore, empirical studies show that its asset-backed and risk-sharing principles can enhance and ensure resilience during financial crises, while instruments like *Zakak*, *Qard Hasan*, and shari'ah-compliant microfinance support socio-economic welfare. Nevertheless, Islamic banking is also facing challenges, such as regulatory harmonization, Shari'ah governance consistency, product standardization, and balancing authenticity with competitiveness. There is the need to address these issues through stronger legal frameworks, innovation aligned with Shari'ah objectives (*Maqasid al-Shari'ah*), and improved human capital will be crucial for its future growth. Islamic banking would be able to offer a credible and ethical alternative to conventional finance and with the potential to contribute meaningfully to inclusive growth and financial stability when its principles are honestly, and faithfully implemented and continuously refined. More information on Islamic Banking can be found in

the books in [29-36] and the following related journals:

International Journal of Islamic and Middle Eastern Finance and Management

Journal of Islamic Accounting and Business Research

Islamic Economic Studies

Journal of Islamic Economics, Banking and Finance

International Journal of Islamic Finance

ISRA International Journal of Islamic Finance (IIJIF)

Islamic Banking and Finance Review (IBFR)

Journal of Islamic Banking, Economics and Finance (JIBEF)

Jihbiz: Global Journal of Islamic Banking and Finance

Ihtifaz: Journal of Islamic Economics, Finance and Banking

Economics & Islamic Finance Journal (ECIF)

Journal of Sharia Banking (JSB)

AL-ARBAH: Journal of Islamic Finance and Banking

Journal of Finance and Islamic Banking (JFIB)

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Figure 1. Islamic banking and finance

Source:

https://en.wikipedia.org/wiki/islamic_banking_and_finance



Figure 2. Islamic Development Bank

Source:

https://en.wikipedia.org/wiki/islamic_development_bank



Figure 3. Riba

Source:

<https://en.wikipedia.org/wiki/Riba>

Musharaka Contract

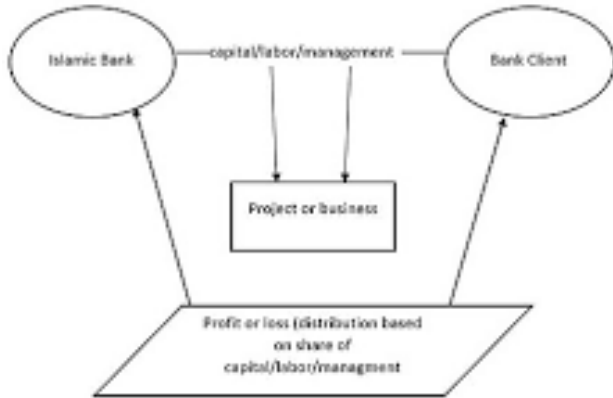


Figure 4. Profit and loss sharing

Source:

https://en.wikipedia.org/wiki/Profit_and_loss_sharing

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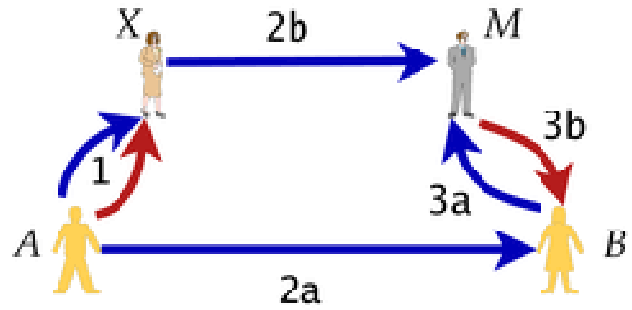


Figure 5. Islamic financial products, services and contracts

source:

https://en.wikipedia.org/wiki/Islamic_finance_products,_services_and_contracts

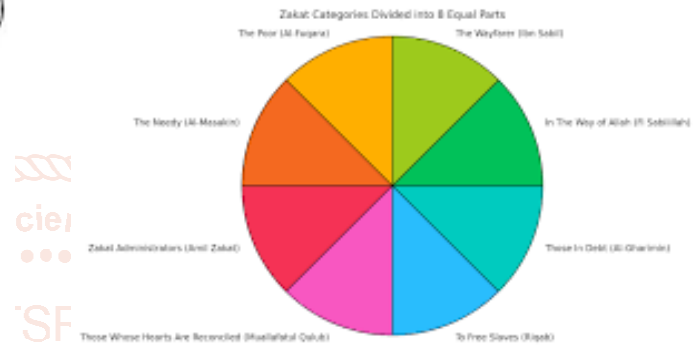


Figure 6. Zakat

Source:

<https://en.wikipedia.org/wiki/Zakat>