

ISLAMIC BANKING MECHANISM AND PROSPECTS- A STUDY WITH SPECIAL REFERENCE TO SELECTED BANKS IN OMAN

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Abstract

Banking is a very decisive part in a country, playing its role as a mobilizer of the currency and initializing continuous contribution to the development of economy. "Interest" which is a major element in most of the banking transactions and also a wide source of revenue for bank itself. What happens if that is not available in the system of banking? The present study focus on the mechanism and prospects of the contemporary model of Banking where, the interest is not found- called Islamic Sharia Banking. The study focus on how the Islamic banking platform works, and also whether this practice of financial mechanism is really able to contribute the development of economy. Organizationally, this paper sets together a rich combination of Impartial evaluation of Islamic Banking from several outlooks and assists as an essential source of material on Islamic Banking in Oman for different users especially Islamic Banking practitioners, Academically, this paper also delivers appreciated source of literature for scholars and consultants interested in Islamic banking research and business in Oman Banking Industry.

Keywords: Banking, interest, Sharia, Islamic Banking.

Introduction

The origin of banking can be found from the initial times of human antiquity. Its origin can be found with the first pattern banks of business people of the primeval world, where people use to do the business between cities in those times. Previously people use to store the money in the place where they felt more safety. The habit of storing money and other valuable metals at safe area and advancing currency was customary in ancient Rome⁷. Gradually the traditional banking has taken a route of Modern banking by way of Merchant banking, financiers, private bankers etc. these bankers provide safety, integrity and reliability to others money.

In the pre-modern phenomenon banking may be understood as a commotion of accommodating and protecting money of other persons and companies, and then advancing out this currency with an object to produce a revenue⁴. But as the time passed the bankers have widened their activities, now they not only deal with currency but also with many other negotiable instruments too which are considered as money equivalents. The various modern activities of present banking includes credit and debit cards, lockers, ATM and CDM services, online banking, national and international fund transfers and many more.

Being interest as a major source of income for the bank on its deposits and also the interest as a return on the deposits of the depositors has made a revolutionary history in the modern era by Islamic religion, where Interest (riba in Arabic) is prohibited. It is considered as a modern phenomenon by some Islamic socialist where as some claim that this particular banking system is as old as the Islamic religion itself, and based on the principles derived from Holy Quran⁸. The Islamic banking is the way of banking which follows the Sharia (Islamic Laws). It can also be named as Sharia compliance finance. Egypt is the first country marked as the beginner of Islamic banking system in 1963 based on a system of Mudarabah the profit sharing agreements. Later with the establishment of Islamic Development Bank (IDB) in Saudi Arabia in 1975 has made a revolutionary history of growth in Islamic Banking. In 1977 International Union for Islamic Banks in Mecca has further took an initiative step for creating cooperative links and coordinating all Islamic banking activities.

Review of Literature

Though it is claimed that Islamic banking is as old as Islamic religion itself, its awareness and formal application in the real time are of still in inception stage¹, Hence more literature is difficult to be found, but it can be sufficiently cited with the following reviews:

According to Hassan, Kayed, & Oseni, 2013⁶; Hassan, & Lewis, 2014⁵ Islamic banking is the system which is purely based on Islamic laws and principles, where such four basic philosophies of Islam in trade governs the activities are: prohibition of Riba (interest) which both giving and taking is considered as haram in Islam. The second principle is prohibition of Gharar, which refers to those monetary transactions where there is excessive risk is involved, such as betting/gambling. In Gharar transactions there is high risk and resultant loss to one party and excessive profits to the other and also full information is also not disclosed and kept hidden. The third principle is prohibition of Maisir (Abedifar, Ebrahim, Molyneux, & Tarazi, 2015), which refers improper, sinful acts such as bribery, drugs, liquor, prostitution, pig meat etc. these are prohibited as these acts exploits the justice, and detrimental to human life and society. The fourth principle of Islamic banking is ensuring that all financial transactions are linked to real monetary transactions and valued to both contractual parties and society too.

Dar, Humayon A. 2010³ demonstrated that Islamic Banking products are in many methods based on the Islamic funding approaches, which include (i) Mudarabah, the facility of capital in a limited equity partnership; (ii) Musharakah, complete equity partnerships, (iii) Murabaha, an tool used for financing the procurement of merchandises; (iv) Bai muajjall, deferred payments on products; (v) Bai Salam, early payment sale contracts; (vi) Istisna, are manufacturing deals; (vii) Ijarah, tenancy financing; and (viii) Quard Hassan, is the structure of generous loans.

To study about the stability of Islamic banks compared to conventional banks, a study has been done by Mat Rahim, Mohd Hassan and Zakaria (2012)¹¹ in Malaysia taking seventeen Islamic banks and twenty one other traditional banks using z-score model and found that Islamic banks are more stable than traditional banks.

A further prevalent study has been conducted by Cihak and Hesse (2008)² using the database from Bank scope where 77 Islamic banks and 397 traditional banks are studied using z-score model and found that Islamic banks are more stable than other banks in small and mid-scales whereas at large scale traditional banking plays a dominant role due to complexities of credit risk management in Islamic banks.

A relevant study has been undertaken in Pakistan by Shahid and Abbas (2012)¹⁰ taking the data between the period of 2006 and 2009 with top ten banks and found that a platform of credit rating Islamic Banks are more stable than Conventional banks in Pakistan.

Muhammed Iqbal Anjum (2016)⁹ conducted a study on "An enquiry into alternative models of Islamic Banking" and has found that there is a lot of scope for the and unutilized potentiality in the area of Islamic banking at global level, the same can be utilized by realization of independent Pan Islamic monetary regime based collaboration among at least several constituents such as Baithul mal, Islamic treasury, Islamic capital market etc. of Muslim Ummah.

Objectives

The objectives of the study are:

1. To study the mechanism of the Islamic banking system with the help of selected banks.
2. To evaluate the prospects in the system of Islamic banking.
3. To assess the contributions of the Islamic banking system through selected banks, in the overall development of the country's economy.

Research Methodology

The study is based on secondary data through various websites, newspapers and journals of banking.

Islamic Banking in Oman

Among all the Gulf Cooperation Council (GCC) countries Oman stands in the last place to start Islamic banking in the banking and finance sector¹⁴ in December 2012. Initially during the first year of its inception the growth of Islamic banking stood at a low pace, but slowly due to the preference and choice of consumers it has stood a great way of success in the era of banking. It has been also found according to the survey conducted by IFAAS in 2011 that Islamic banking has a greater prospect and also may have majority shareholding in the overall banking assets.

Islamic Banking Mechanism

To study about the mechanism of Islamic banking two banks have been selected where an attempt has been done to know the process of banking that is done through Sharia compliances.

Bank Nizwa

Bank Nizwa is the bank which has been formed under the grant of central bank of Oman approving its first license to Sheik Saud bin Ali Al Khalili and later other 92 Omani partners have also joined in the group. The major shareholders of the bank are companies and pension funds.

Bank Nizwa is the first dedicated bank in Oman which has been implemented Islamic Banking with full Sharia Compliance in both products as well as services¹⁵. The products of Bank Nizwa's Islamic banking are bounded with the license terms by Central Bank of Oman and Banking Law publicized by the Royal Decree No. 114/2000 of Oman. Some of the laws of the official decree which must be followed by the Board of Governors or Directors of the bank are as under:

- Accept the deposits and management of investment accounts with or without profits and fees.
- Investments and financing should and only should be done in the form of Musharak or Mudaraba or Ijara or Murabaha or Salam or Istisnaa or Qardh Hasan or any other Sharia principles of contract.
- Issue of and Investment in Sukuks backed by assets and projects.
- Purchase, sell, hold, invest, lease, rent of movable and immovable properties in exception of limitations provided for in the banking law and other laws and Royal Decrees applicable in the sultanate.

Following these compliances and Banking rules Bank Nizwa now provides an occupied range of banking solutions to all most all segments of customers which includes individuals, small and medium sized business, corporations and even Government institutions too by its varied products.

Mechanism and Products of Bank Nizwa

1. **Musharaks Mechanism:** It is a form of partnership where an agreement between two or more parties is done to contribute to a business which is existing or new. The profits are shared according to the agreement between the parties, but the losses are shared based on the proportion to their capital contribution. This mechanism may benefit the needy people where the profit contributions are flexible based on contract whereas loss contribution is constant.
2. **Mudaraba Mechanism:** It is the arrangement between parties where one party called rab-al-maal make available funds to other party called mudarib which invest in a sharia compliant enterprise. Here the risk of loss will be borne by capital provider.
3. **Murabaha Mechanism:** It is similar to cost plus make up strategy where an agreement that one party sells an asset or commodity to other, which it has been purchased by the former based on a promise from second party to buy the asset on specific terms. The price of the asset includes the cost plus an agreed mark of profit. The payment terms under the Murabaha structure is

fixed in the agreement whether it is paid in installments or lump sum. This mechanism is to facilitate short and midterm asset financing requirements.

4. **Istisna Mechanism:** It comes under the segment of manufacturing where, there is an agreement between bank and customer where banks sells to customer a developed property to be developed according to the set of agreed terms. The bank will develop the property by its own or a sub agent/contractor and handed over to the customer.
5. **Ijara Mechanism:** The segment of leasing contracts where bank the lessor purchases the asset for lease upon customer the lessee request. The customer promise to lease the asset for a specific period and to pay rent instalments. This special agreement results the ownership of the asset to the lessee.
6. **Salam:** The Forward sale: is a contract where goods are delivered at a specified future date but sale price is fixed and paid in advance. The ownership of goods will be transferred immediately one date of contract.
7. **Sukuk:** These are the asset backed securities of equal value evidencing common undivided ownership of tangible assets. These agreements bear fixed or variable profits rate paid to investor set out in contract terms.

Maisarah Islamic Bank

Bank Dhofar one of the most renowned bank in Oman, as a part of Islamic Banking has started its operations in the name of Maisarah bank. The word Maisara in Arabic means “ease” representing easiness to customers in their banking transactions¹⁶.

Mechanism and Products of Maisarah Bank

The major products of Maiasarah banks are,

- **Savings Account:** these accounts are purely based on sharia compliance under Mudharaba. The account opening process is very simple easy and also available to interested expat customers too.
- **Current Account:** this is a form of account which is available to corporate customers. These contracts are based on Qard al Hassan- a sharia compliance. It is a form of benevolent loan which interest free provided to corporate customers.
- **Auto Finance:** financing facilities to the customers interested in buying automobiles where new and used cars can be bought in finance paid in easy monthly installments. The Auto financing is done based on Murabaha sharia compliances.
- **Home Finance:** This product facilitates to buy a house in Oman and is based on sharia through Ijara contracts.
- **Fixed Deposits:** it is based on Mudarabah sharia compliance where investors can invest their savings for period of 1 month to 5 years and earn a profit on periodic basis.

It can be observed from the modus operandi of both the banks that all the transactions and products though the names are different, are purely based on Islamic sharia compliance where, the Interest / Usury (Riba) is completely ignored which is treated as prohibited for Muslims. Interest is the excess compensation received or increased without any due consideration. And the contracts which dealt with interest is coped with higher risk and also floating of money to one or some group of individuals which makes rich richer and the poor poorer. Hence it is considered as illegal in Islam as it intensifies justice and equality and raise brotherhood to a strong extent. Therefore the usury has been replaced with profits which has risk sharing both at the time of positives and negatives in business dealings. Hence if the investments acts result in positive results the investors enjoy profit sharing and also at the same time any negative picture results in equal sharing of loss among all the investors. In this way the money will be distributed evenly without the flow in only one side.

Prospects of Islamic banking in Oman

Though the Islamic banking is a new segment of banking in Oman and Oman is the last among the GCC nations to implement the sharia compliance banking industry has showed a great prospect in the banking era and has played a major contribution in the economic development of Oman. The Islamic banking has been started in 2012 end in Oman but from the date of its inception within three years i.e, in 2015 it was able to reach 2.25 billion Omani Rials in the gross assets with a market share of 7.45%¹². Bank Nizwa with the collaboration of Al Aziz Islamic bank was able to emerge with sixty branches by the end of 2015.

There has been a continuous changes and amendment has been intensified by Central bank of Oman and Royal decree taking measures to improvise and make customers aware about the benefits of Islamic Banking. The Modern guidelines on sukuk (Islamic pledges) are serving initiative progress in Oman’s Islamic banking sector, with sharia compliance financiers attainment ground. Development of Islamic banking is outlying outstrip that of regular banking section with Islamic banking possessions up more than 62% year-by-year at the end of March 2016. Capital Market Authority (CMA) in April 2016 has also issued with new regulations concerning the issuance of sukuk will further widen the segment’s base by reassuring corporate issues. Complete assets detained by Islamic banks and the Islamic banking frames of regular banking creditors in March was amounted to 2.5bn Omani Rial (\$6.5bn), when equated to 1.5bn Omani Rial (\$3.9bn) one year earlier. This grabbed the Islamic banking’s market share from 5.5% of the financial structure’s overall assets in 2016 to 7.9% by March 2017¹³.

According to latest Moody a credit rating agency report of November, the financial outlook of this year predicted that the Islamic banking assets would account between 10% - 12% of total banking assets by next two years¹⁴.

When analysis based on financial statements is done referring the selected banks, it has been found that; Bank Nizwa’s total revenue for the quarter end of March 2017 is OMR 5,306,127 out of which Islamic banking related transactions revenue shared to the extent of OMR 2,856,843 and Musharaka revenue¹⁷ of OMR 62,777. Hence the contribution of Islamic revenue in the total revenue of Bank Nizwa is 55.022%. The total assets of bank Nizwa for Quarter end march 31 2017 are OMR 562,469,323 out of which Ijara Mununtahia Bittamleek net net assets are OMR 248,680,590 that is equal to 44.212%¹⁵. This shows how better the Islamic banking leads to the total profit and assets contributions to the bank.

Maisarah Banks has a consolidated reports merged with Bank Dhofar, there are no separate accounts maintained for Maisarah bank. As per the financial reports Quarter end of March 31 2017 of Bank Dhofar the income from Islamic Financing is OMR 4,068 contributing 12.68% of net operating Income¹⁷ of OMR 32,064. Thus it can be seen that Islamic operations are prospering to a great extent to contribute the economic development of Oman.

Islamic banking bodies delivered funding to the extent of RO 2.5 billion as at the end of January 2017 when paralleled to RO 1.8 billion a year ago. Total deposits detained with Islamic banks and windows also shown a significant increase to RO 2.2 billion in January 2017 from RO 1.5 billion unresolved as at the end of January 2016. The total assets of Islamic banks and Windows pooled, amounted to RO 3.2 billion as at the end of January 2017 which instituted about 10.6 percent of the banking system assets.

The above are the basic monetary contributions made by the Islamic banking segment in Oman, along with these there are many other contributions are also provides the opportunity to develop the country's economy such as creating an high employment opportunities to the citizens, awareness of Islamic sharia compliances in finance related matters by offering special training to the customers by various banks. Islamic banking is also able to provide high demand for banking products related to Islamic banking and conventional banking too.

Conclusion

The present study is ought to provide an insight in to process and prospects of Islamic Banking in sultanate of Oman. Drawing from the literature it can be concluded that Islamic Banking is a phenomenon which is not latest but as old as the emergence of Islam, where the sharia practices available in the Holy book of Islam are strictly followed. An utmost care has been taken to formulate the norms of Islamic banking which are strictly adhered to Sharia. The introduction of Islamic banking in Oman was able to contribute to a very great extent in the overall economic development of Oman, which includes employment, worldwide expansions etc. Islamic Banking has massive opportunities in Oman for its endurance and progress. Nonetheless, if Islamic Banking establishments are to animate to their dreams worldwide they have to overcome a number of possibly teething challenges. This study provides a general review and is limited to Sultanate of Oman. The Research topic is more empirical and is mandatory to sightsee empirical analysis in the Global level.

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