

# ISLAMIC BANKING AND FINANCE

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## **Abstract**

The purpose of this master thesis is an attempt to elaborate Islamic banks, to examine whether these principles of operating in the market can be practical and furthermore, can it provide alternative methods of dealing with financial problems.

An Islamic banking system is based on the principles of Islamic law (also known Shariah). Two main basic principles behind Islamic banking are the sharing of profit and loss and, significantly, the prohibition of the collection and payment of interest.

In Albanian application, from our research & survey that we had with the customer (clients) of UBA we concluded that Islamic banks are not only used from the Muslim but also from the others. Bank offer the same product as the others. According to the questionnaire, the reason that attracts more the customer to use it is Low risk, new product, confidence problem and diversification.

**Keywords: Islamic banking, banking, Albanian application.**

## **Abstrakt**

Qëllimi i kësaj teme masteri është një përpjekje për të përpunuar rreth bankave Islamike, për të shqyrtuar nëse këto parime të veprojnë në treg mund të jetë praktike dhe për më tepër, ajo mund të sigurojë metoda alternative të merret me problemet financiare.

Sistemi banakar Islamik është i bazuar në parimet e ligjit islamik (e njohur gjithashtu si Sheriati). Dy parimet kryesore dhe themelore rreth bankave islame janë ndarja e fitimit dhe humbja dhe , në mënyrë të konsiderueshme, ndalimi I mbledhjes dhe pagesa e interesit.

Nga aplikimin në Shqipërisë, nga hulumtimet tona dhe studimi që kemi pasur me konsumatorët (klientët) të UBA-së arrijmë në përfundimin se bankat islame nuk përdoren vetëm nga myslimanët, por edhe nga të tjerët. Banka ofrojnë produkte te njejta si të tjerat. Sipas pyetësorit, arsyeja që tërheq më shumë klientet për të përdorur banakat Islamike është rreziku I ulët, produkt i ri, besimi dhe diversifikimi.

**Fjalet Kyçe: Bankat Islamike, Bankat, Aplikimi ne Shqipëri**

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## **Declaration Statement**

1. The material included in this thesis has not been submitted wholly or in part for any academic award or qualification other than that for which it is now submitted.
2. The program of advanced study of which this thesis is part has consisted of:
  - i) Research Methods course during the undergraduate study
  - ii) Examination of several thesis guides of particular universities both in Albania and abroad as well as a professional book on this subject.

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## **List of Abbreviations**

AAIB	Arab Albania Investment Bank
AIB	Arab Islamic Banks
ALL	Albanian lek
AMF	Albanian Ministry of Finance
ATM	Automated-Teller Machine.
BoA	Bank of Albania
BSHSH	State Bank of Albania
CB	Central Bank
GDP	Gross Domestic Product
HSBC	Hongkong and Shanghai Banking Corporation
IB	Islamic Banking
IDB	Islamic Development Bank
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
NCBA	National Commercial Bank of Albania
OIC	Organization of Islamic Conference
UBA	United Bank of Albania

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## **I. Introduction**

The philosophy of Islamic banking is based on risk-sharing. In 1963 Ahmed al-Nadjar an economist from Egyptian tested to integrate Islamic banking principals in the form of saving. This implementation was based on mutual involvement of parties in cases of success and failure. This new activity was till 1976, when 9 banks were working with Islamic principles (Ahmad, 2008). These banks neither add on nor paid interest, in these cases the return which was gained in the condition of success, was shared with the business partners. Thus it works more like saving institution rather than bank.

Islamic banking started it functioning in 1970s. Since the creation it has been gaining popularity and showing steady growth all over the world, with annual growth rate of 10-15%, despite the world-wide economic downturn. Islamic finance is an old terminology and it has been use since the advent of Islam (Solé, 2007). The speed how the Islamic banking is growing all over the world involves also the small countries. Islamic banks are now located in over 51 countries around the world, including the United States, and there are over 300 institutions that qualify as Islamic banking institutions. Islamic finance and investing institutions are the largest growing sector in this industry, growing at 25 % in the year 2010 (“The Uabarablaws”, 2008).

In 1971, Nazir Social Banks is known to be the first commercial bank in Egypt, though its charter never made references to shariah. The first bank based on shariah principles was created by the Organization of Islamic conference (OIC) in 1974, called Islamic Development Bank (IDB) (Kholbutayev, 2009). Currently it has 48 branches which great services. IDB offers higher profits than conventional banking system as well they provide auto, home and personal finance products (Platt, 2008). This bank was mainly engaged in intergovernmental activities for

providing funds for development tasks running into member countries. Its business system involved fees for financial services and profit sharing financial support for projects (Ahmad, 2008).

Islamic banking has been created in developing and industrial countries like Malaysia, Indonesia, Arab Gulf countries. England and Germany has also integrated Islamic products into modern banking sector. The first Islamic financial institution in Malaysia was set up in 1963 the Muslim Pilgrims Savings Corporation. Nowadays Islamic banks are main issues in media and economic world. They offer new product and they raise their presence in market, ranking from USA to China. In Islamic financial law there are some methods of financing such as Musharaka, Murabaha, Mudaraba and Ijarah that hold all the contractual details of the business and some contracts are based on profit and loss sharing draft. Islamic financial system is based on risk sharing among parties and there is not totally obligation on one contracted parties (Ahmad, 2008).

There are many reasons why choosing as master thesis Islamic banking. One of the most important reasons is that, looking for new challenges in banking sector, how to exceed certain financial problems especially in my home country. Islamic finance is not only for Muslims. It is for entire humanity: "We have sent you solely for the mercy of all worlds". (Al Suwailem, 2006). The main banks like Deutsch Bank, Citibank's and HSBC has created special Islamic departments, which can regard as a proof for growing interest towards Islamic Banking. There are almost 2 billion of Muslims all over the world, a statistic that cannot be overlooked even in the banking industry. Muslims have strict laws governing financial transactions. Islamic banking must adhere to the laws of Sharia to be true Islamic banking centers. There are considerable publications in Arabic and Urdu language in the beginning of Islamic banking. The early authors had been simply thinking deeply rather than presenting well thought-out ideas. Thus, for example

the book Qureshi (1946) investigated banking as a social service that should be promoted by the government like the public health and education. In the view point of Qureshi the bank could neither pay interest account holders nor charge any interest on loans advanced. Qureshi also study about partnership between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit-sharing (Qureshi& Iqbal, 1946).

In (1955) Uzair argued that the banks should not make any capital investment with its own deposits represented in his analysis somewhat impractical (Mohammad, 1955).

Islamic concepts consist of six main financing principles.

- 1) Prohibition of riba (interest),
- 2) Introduction of religious levy, zakat,
- 3) Avoidance of gharar,
- 4) Demand of al bay (trade/commerce) in all transactions,
- 5) Prohibition of maisir (speculative, high-risk, gambling),
- 6) Prohibition of participation into the financing of alcohol, pork.

Therefore, briefly, this study tries to study Islamic Bank and Finance and in my case is the only UBA bank that behaves and operates as Islamic banking in Albanian. As it is showed this research is divided into six chapters. The first chapter which is the introduction presents the background of the research, the research problem, and research objectives. Chapter 2 presents a literature review which provides the reader with an overview on the main previously published papers related to Islamic Banks and Finance. Chapter 3, 4 and 5 presents overviews of Conventional Banking Instruments and Financial Intermediation and Monetary Policy in Islamic Banking. The methodology used is presented in Chapter 6. It shows the method and procedure

made in this work. The data are collected by the questionnaire in which it was delivery as a survey to the UBA customers. This study ends with conclusion.

## **II. Literature review**

Islamic banking starts its activity in 1963 in Egypt. The success of this experiment opened the doors for a separate and distinct market for Islamic banking and finance. In the beginning Islamic banks were introduced in Arabic and Asian countries. Most of these Islamic banks were in Islamic countries. Today's, Islamic banks are operating in more than sixty countries. Muslim countries has increased from 2% in the late 1970s to about 15% today (Aggarwal and Yousaf 2000).

Hasan (2005) describes Islamic banking as follows "One must see Islamic banking as an on-going process in a social milieu characterized with mass poverty and gross inequalities in the distribution of wealth, income and opportunities". The main goal of an Islamic banking and financial system are to: 1) Implement the value system of the Quran and the Sunnah, (2) Foster growth of the economy of Muslim nations by developing financial markets, instruments and institutions, (3) Dampen the shocks of extreme economic output by promoting risk sharing instruments.<sup>3</sup> Islamic law does not object to payment for the use of an asset, and earning of profits or returns from assets is indeed encouraged as long as both lender and borrower share the investment risk together (Jobst, 2007).

Chong and Liu (2009) state that from a theoretical perspective, Islamic banking is different from conventional banking because *riba* (interest) is prohibited in the Islam. The conclusions of their research shows that Islamic deposits are not completely interest free at all because of competition and agency problems. Even Islamic banks aim to be completely interest free. Chong and Liu consider this impossible. Some other Islamic scholars state that the aim is a balance sheet free from interest banking product but other scholars state that some interest bearing product could be contained if the balance is positive for non interest bearing products and other principles of Islamic banking are not harming.



Hussein (2003) another scholar finds that smaller Islamic banks operate more efficiently than their larger counterparts in Sudan and that banks with a larger proportion of musharakah and mudarabah financed relative to total assets have efficiency advantages.

Abdus Samad (2004) in his paper examines the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks during the post Gulf War period 1991-2001.

### **III. Conventional Banking Instruments and Financial Intermediation**

In conventional banking system there are many types of financial instruments used for liquidity management. There is no issue of interest. Conventional banking system use to have both type of financing that is, equity and debt financing, and both type of financial instruments in market for trading. Bills of exchange and other commercial papers are financial instruments which are used in conventional banking for liquidity management as an instrument of debt financing. Both exports and imports are financed by a manner of bill of exchange. Like bill of exchange approved it becomes the marketable security and can be trade in market, and its market value rely on interest rate and maturity life (Wilson, 1991). As, no interest exists in bill of exchange but its value is depends on interest. But in Islamic banking its rate does not depend on interest. Both systems use to have similar process but the difference is on the market value of bill of exchange and principles of transactions.

In conventional banking system there are various types of deposits. Deposits of the bank depend in the public likes. In case of high interest rate the bank's deposits raise automatically and if customers request to withdraw some cash through ATM the bank's deposits decline. On the other side, there are no deposits in Islamic banking but customer acts a partner through Musharkah, Mudarbah and Murabaha, etc with bank. In fact deposits are the loan which is presented to commercial bank by customers but in Islamic banking customer acts as a business partner with bank

Islamic banking appeared on world forum as an important player over two decades ago. But really many principles of Islamic banking system have been generally accepted all over the world for centuries rather than decades (Ahmad, 2008).

The OIC defined an Islamic banking as “a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic shariah and to the banning of the receipt and payment of interest on any of its operations” (Hassan, 1999).

According to this statement, interest is strictly prohibited in Islamic law due to its negative effects on human being and more badly effects on overall economy and society. In an interest based economy a trend that rich people create the methods to increase their wealth through effecting the middle and lower classes. In interest based economy the middle class cannot support positively in economic system then gradually the economy travel at financial crises such as credit crunch. Business operation in Islam is based on fairness, justice and parity.

In Islamic bank is called as unfairness when provider of the loan is guaranteed fixed return. In conventional bank depositors generally obtain fixed amount of rate return and through deposits banks often raises funds. In Islam is strictly forbiddance any form of interest or fixed return. There are no other obstacles that would control any party form mutual interaction and risk sharing. This regulates and organizes banking activity in such a way, where parties would receive income for their own savings depending on the result of the business transaction. So in simple way the depositors may not obtain fixed income for their saving, but they will paid the portion of the income that bank earned from the project. Banks cannot demand fixed return for a loan, but can interact with the borrower in risk and income sharing (Obaidullah, 1999).

But in conventional banking system which deals with debt contracts, requiring ex-ante fixed rate of return burdens debtor who carries out most the risk.

In conventional bank depositor is usually obtain fixed amount of return and through deposits banks often raises funds. In the case floating interest rate which is linked to some benchmark LIBOR, depositor is not guaranteed for fixed value of return, in any case the fact is that interest

rate can't be negative, thus riba exist in every debt as depositor is entitled to an amount in excess to the amount deposited. Besides being the major source of raising funds, conventional bank is also engaged in borrowing from other financial markets involving riba. A business transaction in Islam is based on the equality and fairness. It's regarded as unfairness when provider of the loan is guaranteed fixed return regardless of the outcome of the transaction. That's why most Islamic financial contract is based on profit and loses sharing. The profit and lose principal is acceptable in Islamic finance as the owner of capital can legitimately share his earned profit by the agent. In profit and lose principal only profit-sharing ratio is determined, while fixed rate of return constitute riba, thus prohibited by sharia. If terms of the contract are transparent and clear for parties which is line with Shariah law, risk and uncertainty on future cash flows, outcomes of business transactions, investments into physical assets with the help of musharaka and mudaraba, are tolerated. All financial contracts and service are legitimate if they do not drop down any of prohibition of Islamic finance principals. All Islamic financial contracts are created by jurist that relies on Qur'an and Hadith (Institute of Islamic Banking and insurance, 1990). There are four classes of commercial contract, investment contracts, trading contracts, supporting contract and gratuitous contracts (Rabiah & Adawiah, 2007).

**Investment contracts** are used to transform funds from surplus to deficit entities, thus becoming intermediation contracts, which is needed for better resource allocation. In investment contracts Musharakah (equity partnership) and Mudarabah (fund management) are mainstream contracts for capital investment.

**Trading contracts** involve sale, mutual partnership, lease etc. This contract can be into two components. First type of contracts deals mainly with operational and financial leasing. Second

component is more concerned with sale, which includes deferred purchase, manufacturing, deferred payment sale and etc.

**Gratuitous contract** does not carry any significant income to banks these contracts involve Gift, Waqf, Loan, Ibra; they are designed for social benefit.

**Supporting contracts** are created for effective and transparent execution of contracts.

Principles of Islamic finance could have helped avoiding the crisis, and could also help to recover from it. Islamic finance also gives an important role for non-profit activities, which act as economic and social safety net in case of downturns and recessions. Islamic principles of finance promote productive and stable economic activity (Al Suwailem, 2009).

Table: 1 Differences between Islamic and conventional banks

Islamic Banking	Conventional Banking
The function and operation methods of Islamic banks are based on the principles of Shariah	The function and operating methods are based on fully manmade principles.
Risk is sharing between the investors and the user of funds(entrepreneur)	The investor is assured of a predetermined of interest rate.
It's goals are maximizing profit but according to the Shariah restrictions	Its goals are maximizing profit without any restriction.
One of functions of Islamic banks is the Islamic banks to be a Zakat Collection Center and they also pay out their Zakat	It doesn't deal with Zakat
Participation in partnership business is an important function of the Islamic banks(riba is prohibited)	Lending loans and getting it back with a compound interest is one of the important functions of the conventional banks.
For the Islamic banks, it must be based on a Shariah approved underlying process	For the commercial banks borrowing from the money market is easy.
The Islamic banks pay more attention to developing project appraisal and evaluations since it shares loss and profit	The conventional banks pay less importance to developing expertise in project appraisal and evaluation since income from the advance is fixed.
The Islamic banks have no provision to charge any fee from the defaulters. Just small amount of compensation and these amount is given to charity	Additional fees are charge in case of defaulters.
Islamic bank can only guarantee deposits for deposit account, which is based on the principle of al-wadiah, thus the depositors are guaranteed repayment of their funds, however if the account is based on the mudarabah concept, client have to share in a loss position..	Conventional bank has to guarantee all its deposits.
The status of Islamic bank is in term to its Clients of partners, investors and trader, buyer and seller.	The status of a conventional bank, in relation to its clients, is that of creditor and debtors.

Source: Mabid et al., 2009.

#### **IV. Islamic Financial System and Institutions**

For the development of an economy banking system is considered very important. Conventional banks are banking system that based on a fixed rate of interest. Banks as an intermediary borrow from savors leading to pay interest to them and also they lend to borrowers that lead to gain interest from them. In conventional banking system, saving and consumer finances are treated differently than in Islamic Banking. Because in Islamic banking the saving of customers are invested in halal business and the profit earned by the bank is shared between parties according to agreed proportional agreement. The both banking system has same objectives and practice, the only difference of implementation of interest is totally prohibited in Islam. Islamic banking almost provide same service as conventional bank such as current accounts, saving accountants, insurances, mortgages and investment opportunities in the society.

An Islamic bank refers to the banking institution directing all known banking activities including lending and borrowing without interest. It manages the funds on basis of Mudaraba and Wakala and accepts demand deposits without interest and free loan these banks organize funds on profit and loss basis (Al-Jarhi, 2001). The Islamic banking system is a significant component of Islamic finance. Islamic finance has unique characteristic because its foundation is laid on the principles and rules of Islamic law (Sharia), which notices that everything is owned by Allah and man has only been allowed to use it. Accordingly, the use of funds is governed by some regulations.

Financial institutions have various key roles in the financial system. Financial institutions are needed to release several financial markets, to provide exchange of funds, setting up principles to effective functioning of existing markets, providing clearinghouses which more or less decreasing main problems of moral hazard and asymmetric information. The next key role is to overcome market failures. It provides intermediary services of the debt and capital market.

Depositors in Islamic finance can use other contracts in order to take part in profit-loss-sharing contract. The contracts are Mudarabah and Musharakah.

Savers can invest into the projects through financial institutions which is fully compliant with Shariah law. Savers generally do not and can't assess profitable projects; Islamic financial institutions constitute the best method to overcome this problem. As in conventional banking there are several types of Islamic institutions. They are central banks, non-bank financial institutions, commercial banks and Islamic insurance funds. Central banks have an important role in Islamic financial system. In most Muslim countries majority central bank act the same way as in conventional central banks.

The principals of Islamic banking reliance on Sharia, commercial banks had concentrated majority of financial activities of Islamic banking. Financial funds of Islamic banks are shown from two major sources. They are the deposits of agents at several accounts and contributed capital of shareholders. Banks accept deposits two types of accounts. They are mudarabah and current accounts (Institute of Islamic Banking and insurance, 1990).

Mudarabah accounts are offered usually by the Islamic banks under which a bank along with its own capital invests depositors/shareholders funds into projects. Profit sharing ratio is approved before the start of the financing. In the circumstances when profits run it is divided by the bank and shareholder. On the other side if the loss accrues liability of the depositors will limited to their share of capital. These kinds of accounts are used in short, medium and long term and can be renewed upon the ending of the contract. Islamic banks play important role in Islamic finance. Commercial banks had concentrated majority of financial activities of Islamic banking. Growing demand of different forms of segment financing forced Islamic banks to specialize more on certain banking activities (Ahmad, 2008).



## **V. Monetary Policy in Islamic Banking**

Mishkin (2007) posted that; the modern science of monetary policy is based on the idea that the central bank's aim is to maximize the economic well-being of the households in the economy. In recent years a growing consensus has emerged to improve price stability to the overriding, long-run goal of monetary policy. Thus it is not surprising that a central feature of monetary policy strategies is the use of a nominal anchor in some form. There are four basic types of monetary policy strategies, each of which uses a different nominal anchor: 1) exchange-rate targeting; 2) monetary targeting; 3) inflation targeting; and 4) monetary policy with an explicit goal, but not an explicit nominal anchor.

Monetary policy is the management of a nation's money supply and maintaining real cost of money to fulfill economic goals by a central bank. In a capitalistic system the primary instruments of monetary policy are discount rates and open market operations (Rahman, 2012). The government uses monetary and fiscal policies in turn to monitor and stabilize macroeconomic indicators as GDP, inflation, employment. The aim of fiscal policy is to achieve economic goals through taxation and government expenditure. The central bank takes either shrinking monetary policy or expansionary monetary policy in order to control inflation and exchange rate regime by controlling money supply across open market operations, and also sets interest rates between banks and reserve requirements. As in capitalistic system Islamic system has also the purpose as growth and inflation, but the use of monetary policy is a bit different. In view of Islamic prohibitions these instruments that are sometimes used in conventional system are not available. In principal Islamic ethics prohibits from using these instruments and it concentrates on monetary aggregates and it uses profit rates instruments for application monetary policy (Chapra & Khan, 2000).

## 5.1 Overview of monetary policy

The monetary policy can affect the money supply which in turn changes interest rates so it can fulfill its objective. In Islamic economy, monetary policy is an important tool of public policy like its capitalist counterpart. The main objectives and instruments must be different because of the differences in the goal and the nature of the two systems and because of the prohibition of interest in Islam while it is a key component in the capitalist system (Chapra & Ahmed, 2002). Monetary policy, in Islamic economy should be conforming to the nature of Islam. It should also pointed the socio-economic goals of Islam like, economic well-being with full employment and optimum rate of economic growth; socio-economic justice and equitable distribution of income and wealth; and stability in the value of money to enable the medium of exchange to be reliable unit of account, a just standard of reduced payments and a stable store of value. The demand for money in Islamic economy seems in principles from transactions and precautionary needs which are determined largely by the level of money income and its distribution. The removal of interest rate and the levy of Zakah at the rate of two and a half per cent will tend to minimize the speculative demand for money.

The Islamic central bank should evaluate the demand for money at full employment with the framework of stable prices and other socio-economic goal of Islam and try to control the supply of money. Monetary policy extracted from the Islamic economic principles can be categorized as:

a. *interest free economy*

The suggestion of Islamic economy is interest free. Interest will not only be avoided from the banking system, but also from the economy. Fiscal incentives will motivate new

member in oligopolistic markets and rise competition. The rise of competition will decrease prices to their natural level.

b. *assets backed money supply creation*

The Islamic banks will only be able to keep financing to create assets. Assets backed financing will run in productive activities and the funds will flow to the saving surplus unit to saving deficit units in an efficient method. The problem of very much currency following too few goods will not happen and it will not result in inflationary pressures.

c. *low to moderate inflation*

Four of the most significant drivers of inflation are interest rates, depreciation of money, indirect taxes and price distortions due to imperfect markets. Price manipulation and output restrictions resulting in deadweight loss will not happen in the proposed economic framework. Hence inflation will rise at its natural level. The good in which certain individuals have a major consumer surplus, the price for them can be set higher using price discrimination.

d. *stable exchanges rates*

Exchange rate stability improves if balance of payments situation expands. Balance of payments expands if the country's exports rise at a higher rate than imports. With interest not adding to the cost, it will decline the cost of production and hence makes exports more competitive. With no interest in the economy completed by a wealth tax, equity investment will be boosted and the firms will be in a better position to generate financing through equity mode (Chapra & Khan, 2000).

## 5.2 Monetary policy instruments

Islamic finance uses its contracts in order to fulfill its aims, objectives. As it was already mentioned Islamic economics needs monetary policy to fulfill strategic goals and it plays an important duty as well, but conventional instruments can't be used due to the Islamic prohibitions. In Islamic system monetary authorities use Musharakah certificates as a substitute instruments for interest based control and open market operation. Musharakah certificates are issued on the profit sharing base. If government thinks to reduce money volume in the economy, it sells these certificates and buys it back when it wants to expand money volume. Central bank's release of commercial papers and certificates should be based on productive economic projects, otherwise this principle won't work. Profit rate act as interest rate and central bank can affect individuals whether they should buy money or not by changing this rate (Iqbal et.al. 2013).

**Musharakah certificates:** In view of the major prohibitions, Islamic countries use Musharakah certificates in order to manage volume of money. For example if a state wants to take money from public it can sell these certificates so in this case individuals can participate in investment projects and allowing state to control macroeconomic indicators.

**Profit rate of commercial banks:** Central banks manage banking system deposits by Musharak, Madurabah and Ijarah contracts. It uses depositors' funds it includes into investment projects. For example, by decreasing profit rate it discourages individuals to deposits their funds. Depending on central banks it may orders commercial banks to deposit percentage of their deposits as legal reserve that ranges from 10 to 30 percents.

## **VI. Development of Islamic Banking in Albania: the case of United Bank of Albania (UBA)**

Islamic banking is a recent phenomenon that has taken many observers by surprise. The whole banking system has been Islamized also in Albania. Albania has around 3.1 million of people and 70% of the population of Albania are Muslim, and although geographically the country is part of Europe many understandably categorized look towards Saudi Arabia and other Islamic countries for religious guidance (Muslims in Europe. 2009). Actually, a number of believers and intellectual leaders see one of Albania's future major duties as that of an economic and social bridge between Islam and Christian Europe.

In a joint venture between the Bahrain-based Arab Islamic Bank (AIB), and the Bank of Albania (BoA), Albania is soon to have its own Islamic investment bank, which will both explore and finance investment projects, and provide badly-needed modern banking facilities. The agreement to set up the new Arab Albanian Investment Bank (AAIB) was signed recently in Jeddah by chairman Hisham Ali Hafiz and managing-director Haider Binladen, of the Arab Islamic Bank, and Ilir Burhan Hoti, governor of the BoA in that time.

### **6.1 Albanian Banking System**

Origin and development of the banking system in Albania is closely connected to monetary and financial developments during Ottoman Empire and within all economic and political developments in all Albanian territory. The emergence of banking and financial services related closely with the creation of the Imperial Bank Ottoman February 4, 1863 and which had branches in 4 of the major cities of Albania, namely Shkodra, Janina, Shkup (Skopje) and Manastir.

In 1888 the Turkish Agrarian bank was founded. However a real centralized bank in Albania, and a unified monetary system was yet to be seen. So far under the operation of these two banks in Albania there were multiple foreign currencies that were being used for exchange in markets that were very different from city to city. As the years passed by, the interest of Italian banks in Albania grew. Since an Albanian banking system was not yet created. In 1909, the first of these banks was the Eastern Commercial Bank (Banca Commerciale D'Oriente) which opened its branch in the city of Shkoder under the name of Banca "Tozzi and Company".

November 28, 1912 Albania declares its independence as a state of sovereign on which marks the start of a new era in Albanian history. This event sets up the second stage of the development of the Albanian Banking system. The new government took special measures to create National Bank of Albania. Under the agreement, National Bank of Albania, the authority attributed to the central bank (issuing notes, in Albanian and French, fiscal agent for the government's, trading in treasury bills and letters government securities), as well as commercial activities, such as accepting deposit, commercial and mortgage lending, issuing guaranteed bonds, etc... Albania was set back by the war climate in Europe and the banking system was damaged. The unstable climate of politic, Balkan Wars and the beginning of the First War World conditioned the life of this institution. During First World War, several bank branches Great Powers were opened, such as: Wiener Bank Verein, Pestera Bank and Ungarische Bank. These banks served in financing of their respective armies in Albania. The Albanian government enters into discussions with the Italian government create a new bank of the Albanian state as a society shareholder. 1925 marks the creation of the National Bank of Albania (2 September 1925), in Rome, Italy, as common institution Albanian-Italian with Italian director. After creation, the headquarters moved to Durres. BKSH was founded as an institution issuers and creditors. During 1925 new banknotes

born Albanian Lek, in honor of Great Alexander ("Leka" - ALL) After liberation and the establishment of the communist regime in Albania, B.K.SH becomes the state property, in January 13, 1945 was created State Bank of Albania (B.SH.SH.), with both functions as central and commercial banks. 1990 marks the first signs of liberalization in the Albanian financial system allowing opening of the lending process the private sector in Albania. After the changes in 1990, the country enters into the process of transformation from a communist-owned economy state in a free market economy.

In 1992 was created the BoA, the attributes of Western modern central bank, giving life creating a two-tier banking system in Albania and subsequent licensing of four commercial banks.

- Albanian Commercial Bank,

- Savings Bank,

- National Commercial Bank

- Agricultural and Development Bank.

These banks were licensed in principle as universal banks, by intended to provide a wide range of banking services and financial. Year 1997, is known for Albanian banking system as the year of pyramid schemes. People put all their life savings and sold their property to have money to put in these firms. This was the worst episode in the history of the Albanian Banking system. In Albanian banking system nowadays are 16 commercial banks, two of them are with Albanian capital. ( Cani, Muço & Baleta, 2000).

## 6.2 UBA

In Albania only UBA behave as Islamic bank, but again it has a lot of work to reach the real goal and objective of real Islamic bank. UBA is located in Tirana and carries out banking operations in accordance with Albanian laws and Islamic laws and principles. The UBA's activities include acting as manager, on a trustee basis, of funds invested in accordance with Islamic laws and principles. The UBA was incorporated in Albania as a joint venture between the National Commercial Bank of Albania (NCB), a state owned bank, which had a 40% share, and a group of Islamic investors composed mainly of Shamil Bank 20%, Islamic Development Bank Jedah 15%, Dallah Albaraka Holding Co 10%, other investors 15% <http://www.uba.com.al> .

During 2000, NCB was privatized. After the privatization, the Albanian Ministry of Finance retained NCBA's shareholding in UBA. On 5 November 1992, the UBA received approval from the BoA for carrying out banking operations. Formalities in respect of the registration of procedures were completed on 1 July 1994, which is also the incorporation date of the UBA. UBA is subject to supervision by the BoA. On 11 January 1999, according to the decision of the BoA No.165, dated 11 December 1998, the UBA obtained the license, "for continuing the banking activity in the Republic of Albania", in accordance with Law No.8365, dated 2 July 1998, "On banks in the Republic of Albania". Actually the UBA is on the last procedures of the privatization of the share of the Ministry of Finance (40%), where the potential buyer is the Multilateral Bank IDB that after this transaction will be the main shareholder with 55% of shares. At the end of the year the UBA exercises its activity in these cities: Tirana-Head Office and Main branch and two agencies, in the city of Shkodra, Fier and Durres. The Bank employees 76 staff, including 3 expatriate senior managers (<http://www.uba.com.al> ).

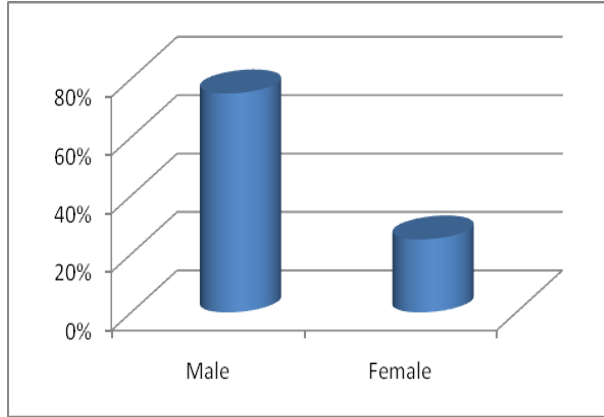


### 6.3 Survey

In my master thesis, I used the questionnaire that I have given to the client's of UBA bank. To help us in our research the questionnaire was selected one of the most successful branches of UBA, main office of UBA. Firstly, I would like to thank them for their collaboration as they immediately accepted to collaborate with us. They thought of it as mutually beneficial, a win – win situation. Many questionnaires were delivered directly to the branch manger by showing him the procedure needed to complete the questionnaire, who later delivered them to his staff, operational and marketing staff. Each staff member helped assisting in the client's completion of the questionnaire by explaining to them the procedure. During the completion of the questionnaire we observed that the UBA main office clients were very enthusiastic about their participation as they could express what they thought about their bank. After collecting them we observed that the number of total questionnaires completed and valid was 350. This number is the limit for a questionnaire to be trusted.

## 1. Gender

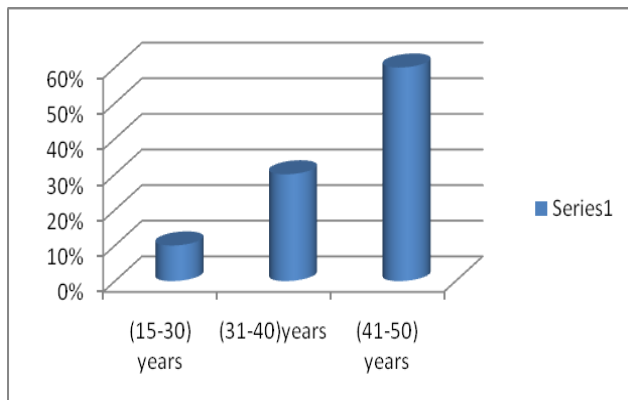
- Male
- Female



The number of participants in the questionnaire was 350 and from the result we found that the number of males is greater than females: male (75%) and female (25%).

## 2. Your Age

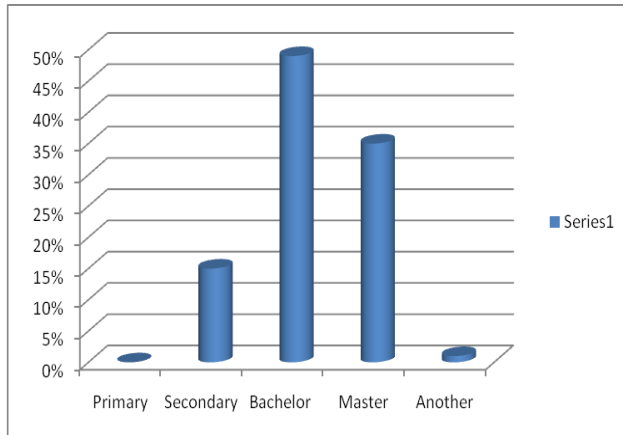
- (15-30) Years
- (31-40) Years
- (41-50) Years
- Above 51 Years.



The third group of participants has higher percentage than the remaining part. Concretely from 41-50 years (60%).

### 3. Your educational qualification

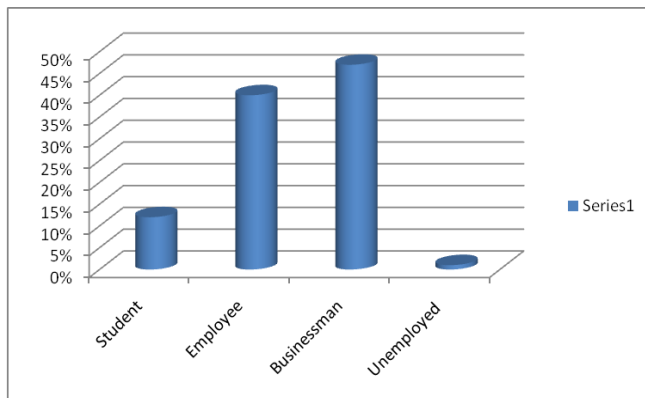
- Primary
- Secondary
- Bachelor
- Master
- Another



According to the questionnaire the respondents are high school, bachelor and master, where high school no. 15%, bachelor no. is (49%) and master no. is (35%).

### 4. Your profession

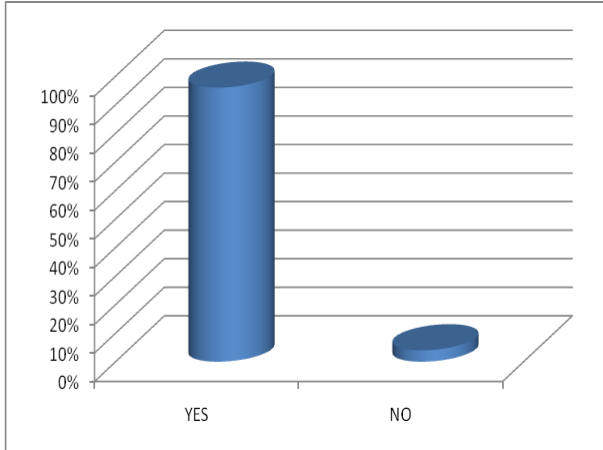
- Student
- Employee
- Businessman
- Unemployed
- Another



As it is obvious from the chart that the categories that work more with UBA are businessman with 47% and employee with 40%.

5. Is your religion Islam?

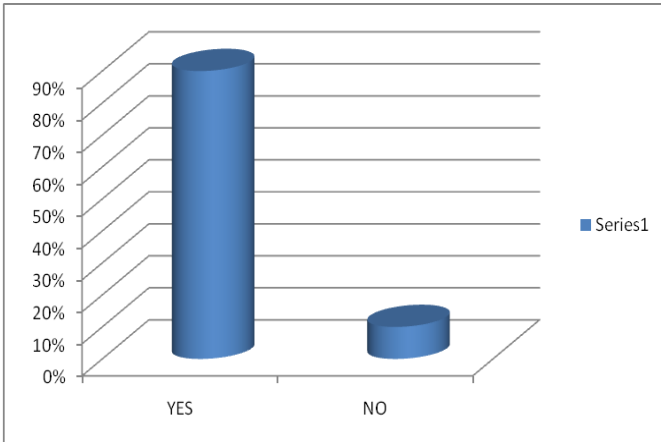
- Yes
- No



As we see from the charter 96% of customers that works with UBA bank are Muslim, and just 4% of it are not.

6. Have you ever heard about Islamic Bank?

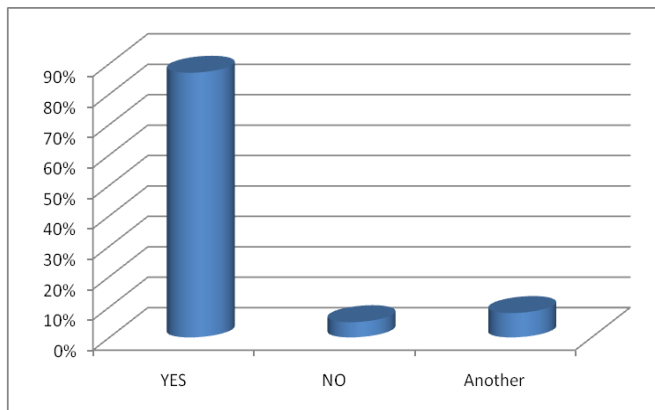
- Yes
- No



Based on the questionnaire's result, most of customers have information about Islamic Banks. (90%) of them has answered yes.

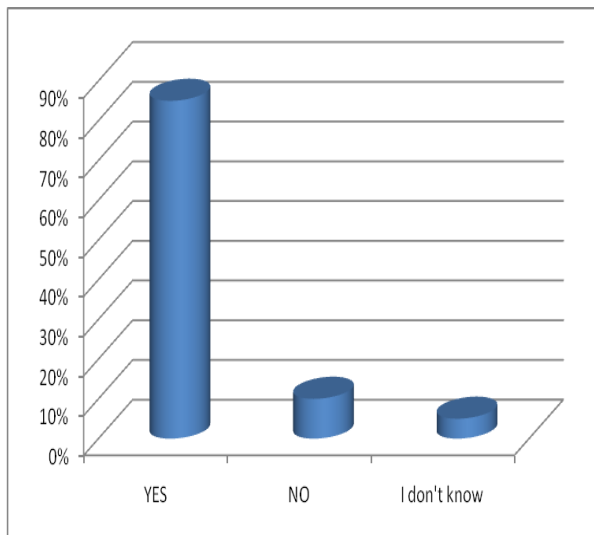
7. Islamic bank do not involve in Riba (Interest), and instead of it use the method of profit loss sharing (partnership). Do you think is it better than western banking?

- Yes
- No
- Another



The questionnaire's result confirms that the 87% of customers' believe that Islamic banking is better than Western Banking and 5% of customers don't think the same, while 8% of customers according to the result think differently.

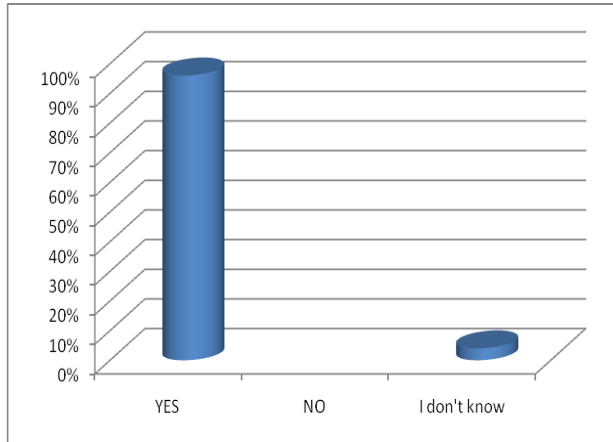
8. Islamic bank do not invest in industries with products and services involved (Alcohol, Pork and Gambling). Do you think is it OK, for welfare of society?



The questionnaire's result 85% confirms that customers think it is Ok for welfare of society and 10% of client doesn't agree with the statement. Just an insignificant no. of clients is undecided about the statement 5%.

9. Is there any Islamic bank in your country?

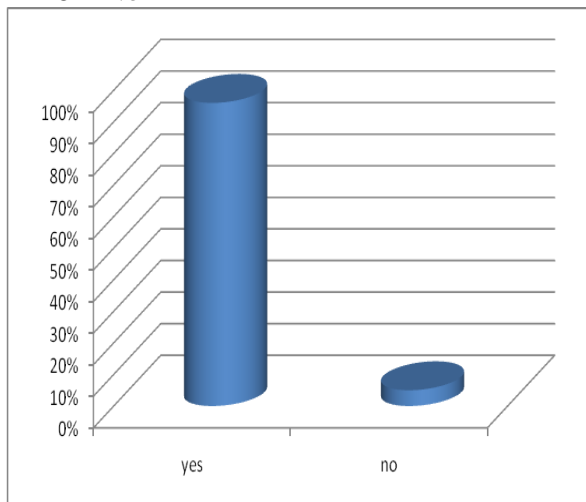
- Yes
- No
- I don't know



Based on the information that the customers has about Islamic Banks, 96% of them know that Albania has Islamic bank, and just 4% of them even that they work with an Islamic bank they don't know about it.

10. If yes. Do you use its services and products?

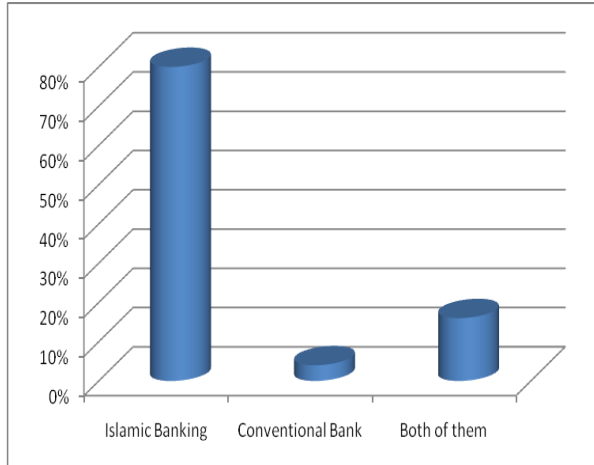
- Yes
- No



Based on the questionnaire's result, 96% of client's use this service and product of the banks, just 4% of them do not use.

11. Which kind of banking system do you prefer?

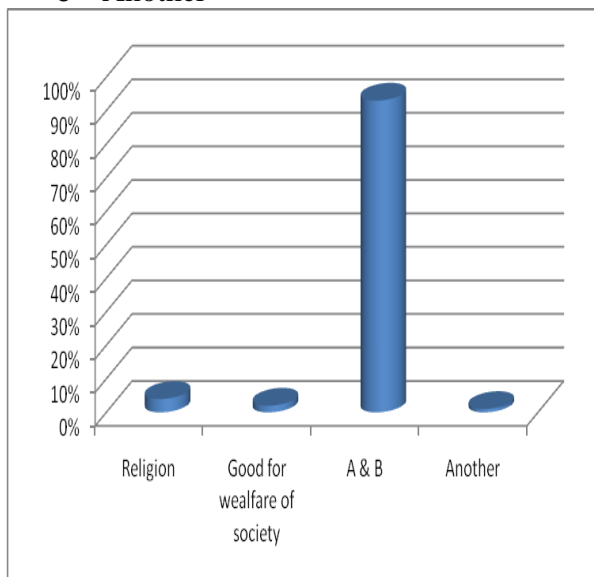
- Islamic bank
- Conventional (western) bank
- Both of them



As it is obvious from the chart that 80% of the clients prefer more Islamic Banks, and 4% of them prefer Conventional Bank and 16% of them prefer both banking system.

12. If you chose Islamic bank, what is the most important reason that attracts you to use Islamic banking system?

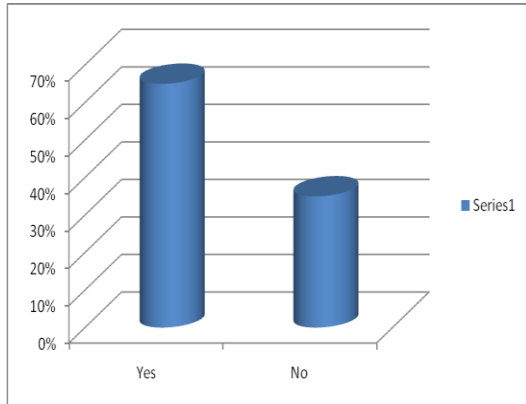
- Religion
- Good for welfare of society
- A and B
- Another



The questionnaire's result confirms that the most important reason of using Islamic banking are both religion and good for welfare of society with 93%. Religion is 4% and good of welfare of society is 2%. Just an insignificant no of clients (1%) are undecided about the statement.

13. Do you work with others banks?

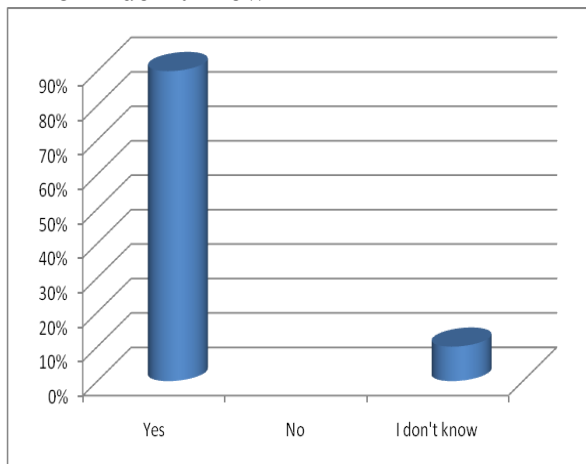
- YES
- NO



According to the questionnaire 35% of clients agree that works only with UBA, and most of the clients work (65%) works also with others banks.

14. Will you use Islamic bank in future?

- YES
- NO
- I don't know

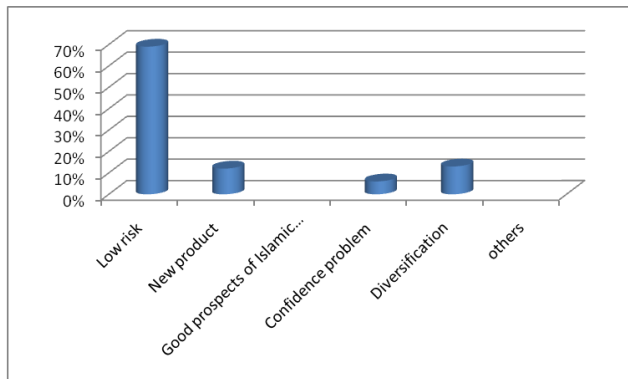


Based on the questionnaire's result, 90% of customers will use Islamic Bank in the future, and 10% of them don't know if they are going to use it.



15. What s the most important reason that attracts you to use it?

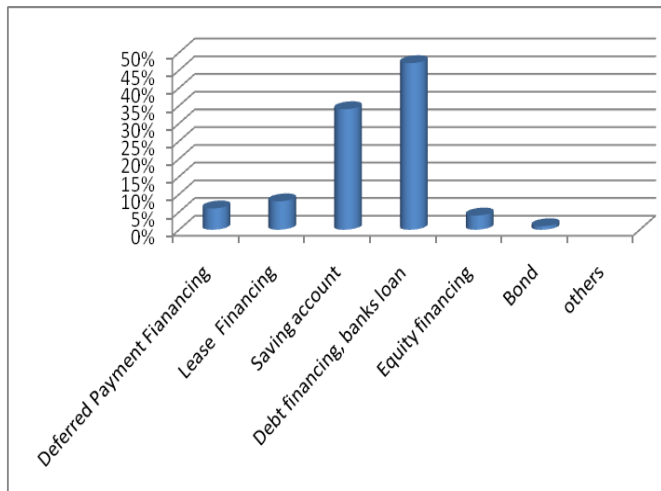
- Low risk
- New product
- Good prospects of Islamic economic future
- Confidence problem
- Diversification
- Others



According to the questionnaire, the reason that attracts the customer to use it is Low risk with 69%, for 12% of them they use it for new product that the bank offers and 6 % of them use it for confidence problem and 13% of them use it for diversification.

16. Which product(s) you are interested in?

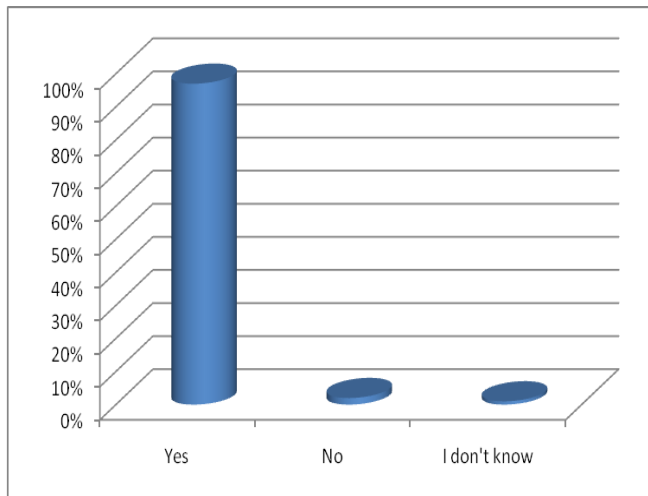
- Bai I Bithaman Ajil( Deferred Payment Fianancing
- Ijara ( Lease Financing)
- Mudaraba ( Saving account)
- Murabaha ( Debt financing , Bank loan)
- Musharaka ( Equity financing)
- Sukuk ( Bond)
- Others



The questionnaire's result confirms that customers are interested in using debt financing, banks loan with 47% and saving accounts with 34% and the other product are also used but with a significant percentages.

17. Do you think that Albania is a suitable place to implement Islamic Bank?

- Yes
- No
- I don't know



According to the questionnaire 97% of customers think that Albania is a suitable place to implement Islamic Bank, 2% of them think it's not, and just 1% they don't know.

## 6.4 General Evaluation

In the 1990's with the opening of Albania to the West, a rebirth of religion – including Islam – came to pass. Along the first years of democracy, the Muslims of Albania managed to build a number of mosques and open few madrasah in the country. Their religious activities were organized by the Muslim Community of Albania. Islam phobia is mediatically produced in Albania even by Catholic intellectuals of Northern Albania and their media, who receive the fact that the majority of Albanians are Muslims as one of the greatest tragedies of their religion and nation.

Albania is a Muslim European country which has about 70 percent Muslim. Islam is now openly recognized as the country's major religion and most Albanians are Sunni Muslim by virtue of the nation's history: The Balkans has had centuries of association with the faith as many parts of it were part of the Turkish Ottoman Empire. While the empire is long gone, the culture remained in place. Significant populations of Albanian Muslims exist in a number of other European countries.

In Albania only UBA behave as Islamic bank. The UBA was incorporated in Albania as a joint venture between the National Commercial Bank of Albania (NCB), a state owned bank, which had a 40% share, and a group of Islamic investors composed mainly of Shamil Bank 20%, Islamic Development Bank Jedah 15%, Dallah Albaraka Holding Co 10%, and other investors 15%. United Bank of Albania started its activity in 1999, it behaves as Islamic bank, but again it has a lot of work to reach the real goal and objective of real Islamic Bank. The primary problems that it faced were as follow:

Islam phobia: Even that Albania is an Islamic community it had a lot of problem in the beginning. Some people hate to hear anything about Islam. Whenever any issue is raised about Islam, they oppose it without bothering to know what it entails.

Ignorance: Some people have no knowledge of what the Islamic banking is all about, all they know is that the Islamic banking has to do with sharia law and sharia law has to do with cutting of hands.

Employment: Some people also feel that only the Muslims would get to enjoy the benefit of employment leaving. Christians losing out of the benefits of the new banking model under the specialized banking department so they feel Islamic banking should not be introduced in Albania.

Islamic banking is not only for Muslim community because it provides moral and more ethical concept of financing and investment. Islamic banking is equaled popular in all communities in the Word. The relationship between UBA and its client in fact is based on creditor and debtor. On the other hand, Islamic bank and its client's relationship are investors and traders, or buyer and seller based relationship but unfortunately in Albania are not same as the other Islamic Banks. During first years that UBA started its activity in Albania it worked as a real Islamic Bank, but during the years its function has change. Most of the customer expectations about product that UBA offer are satisfied with their expectation, for that reason they are their clients of that bank. The aim of UBA is to provide banking services to the community at large, with the purpose to act in the benefit of all human beings, preserving them from harm. Islamic banking is going to be successful it has to be able to compete in the market place as a whole that is against

other Islamic banking organizations as well as the conventional players already operating. The consumer will therefore have access to choice and competitive pricing.

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shari'ah, known Islamic rules on transactions. Islamic banking activities must be practiced consistent with the Shari'ah and its practical application through the development of Islamic economics. Many of these principles upon which Islamic banking is based are commonly accepted all over the world, for centuries rather than decades. These principles are not new but arguably, their original state has been altered over the centuries.

## **Conclusion**

Islamic finance is one of the fast growing segments in global financial service. Islamic banking refers to banking activities according to the principles of Islamic law (Shariah). The main principles of Islamic banking are the sharing of profit and loss among contracted parties and as well very strongly prohibit the Riba (interest). Usually, Islamic banking operations are almost same to conventional banking as Islamic banking institutions also receive deposits and provide financing. The both banking system has same goals and practice the only difference of implementation of interest because interest is strongly prohibited in, Islam. Islamic banks fared differently than did conventional banks during the global financial crisis. Islamic banks performed better than conventional bank during the financial crisis. Islamic finance introduces several contracts with specific investments which are interest free. These are Mudarabah, Musharakah, Istisna, and Ijarah. One of the most important characteristic of Islamic banking is that it operates on the basis of profit and loss sharing. This characteristic makes Islamic banks and capital less risky so increasing its financial sustainability.

UBA is located in Tirana. The Bank's activities include acting as manager, on a trustee basis, of funds invested in accordance with Islamic laws and principles. Currently, the Bank has an Albanian network of 4 branches located in Tirana, Shkodra, Fier and Durres and 2 agencies located in Tirana. UBA behave as Islamic bank in Albania, but again it has a lot of work to reach the real goal and objective of real Islamic bank. The Bank has also been affected during recent financial years. According to the survey that we had with the customer (clients) of UBA we come to a conclusion that the bank is not only used from the Muslim, but also from the other. Bank offer the same product as the others. Most of the customers use both Islamic banks and conventional bank. The categories that work more with UBA are businessman, employee,

students etc. According to the questionnaire, the reason that attracts the customer to use it is Low risk, new product, confidence problem and diversification. The questionnaire's result confirms that the most important reason of using Islamic banking are both religion and good for welfare of society Just an insignificant no of clients are undecided about the statement.

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**Definition of terms:**

**Amanah:** Trust, with associated meanings of responsibility, truthfulness and sincerity. As an important secondary meaning, the term also identifies a contract where one party keeps another's funds. This is in fact the most widely understood and used application of the term, and has a long history of use in Islamic commercial law.

**Gharar:** is uncertainty, speculation

**Halal:** Any activity or transaction permitted in Islam is known as Halal.

**Haram:** Any business or contract prohibited in Islam is known as Haram.

**Islamic banking:** Financial services that meet the requirements of the Sha'riah or Islamic law. While designed to meet the specific religious requirements of the Muslim customers, Islamic banking is not restricted to Muslims: both the financial services provider and the customer can be non-Muslim as well as Muslim.

**Ijara:** Ijara is a kind of lease; it allows the bank to earn profits by charging rentals on the assets leased to the customer. Ijara wa Iqtinah extends the concept to a hire purchase agreement.

**Maysir:** mean gambling, one of three fundamental prohibitions in Islamic finance.

**Mudaraba:** is an investment partnership, whereby the investor (the Rub ul Mal) provides capital to another party (the Mudarib) in order to undertake an investment activity. While profits are shared on a pre-agreed ratio, loss of investment is born by the investor only. The mudarib loses its share of the expected income.

**Mudarib:** The mudarib is the entrepreneur or investment manager in a mudarabah who invests the investors funds in a project or portfolio in exchange for a share of the profits.

**Murabaha:** Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity from a third party and resells it at a prearranged higher price to the capital

user. By paying this higher price over installments, the capital user has successfully obtained credit without paying interest.

**Musharaka:** profit and loss sharing. It is a partnership where profits are shared as per as agreed ratio whereas the losses are shared in proportion to the investment of each partner.

**Quran:** The Holy book of Muslims revealed on Hazrat Muhammad Mustafa (PBUH)

**Qard:** A Qard is a loan, free of interest. Bank use this arrangement for current accounts holders. In essence, it means that Current Account is a loan to the bank, which is used by the bank for investment and other purposes.

**Riba:** Interest, Usury. The legal concept extends beyond just interest but in simple terms Riba covers any return of money on money-whether the interest is fixed or floating, simple or compounded, and at whatever the rate. Riba is strictly prohibited in Islam.

**Shariah:** Islamic law as revealed in the Quran and through the example of Prophet Muhammad (PBUH). A Sha'riah compliant product meets the requirements of Islamic law. A Sha'riah board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of sha'riah compliant products.

**Shariah advisor:** An independent professional, usually a classically trained Islamic legal scholar that advises an Islamic bank on the compliance of its products and services with the sha'riah, or Islamic law. While some Islamic banks consult individual Sha'riah advisor, most establish a committee of Sha'riah advisors.

**Shariah Compliant:** An act or activity that complies with the requirements of sha'riah or Islamic law.

**Sukuk:** Sukuk is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed income, interest bearing bonds are not permitted in Islam,

hence Sukuk are securities that comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Sukuk is a certificate of equal value representing entire shares in ownership of tangible assets and services or the assets of particular projects or investment activity.

**Sunnah:** way of life of Prophet Hazrat Muhammad Mustafa (PBUH); They said about anything, they act anything is called as Sunnah.

**Takaful:** Islamic insurance. Planned as charitable collective pool of funds based on the idea of mutual assistance, takaful schemes are designed to avoid the elements of traditional insurance (i.e., interest and gambling) that are challenging for Muslims.

**Tawarruq:** Reverse Murabaha. As used in personal financing, a customer with an actual need buys something on credit from bank on a deferred payment basis and then instantly resells it for cash to a third party. In this way, the customer can take cash without taking an interest-based loan.

**Wakala:** Wakala is an agency contract which generally includes in its terms a fee for the skill of the agent.

**Zakat:** Zakat is one of the five pillars of Islam. It is obligatory for Muslims to pay their wealth to specified categories in society when their annual wealth exceeds a minimum level.

## **Bio-data**

The author, Besije Manushi, was born in Durres, Albania in 1987. She has completed her Bachelor degree in the Faculty of Economics and Administrative Sciences Department of Banking and Finance in Epoka University and graduated in 2011.

In 2011 she started the Master of Science in Banking and Finance at Epoka University.

The author had started her professional carrier in June 2011 as an account/financier at **PAS+P** Architecture and Marketing Company in Tirana. Later, in May 2013 she started working for Turgut Ozal Education as accountant. She is still working as a accountant in the same company.

The author has also participated various seminars and conferences.

- March 2012 (11-12) Participant in 2nd International Conference on Human and Social Science (ICHSS2012)-Organized by Sapienza University of Rome.
- May 2011(9-10) Participant in International Student Conference on Economics and Finance (ISCON)
- March 2011(25-26) Assistant in Global Perspectives' on the Religious,Cultural,and Societal Diversity in the Balkans
- April 2010 Assistant in Quality and Accreditation in Higher Education
- May 2009 (7) Training of Customer Relationship Management
- April 2009(16-18) Question Based Selling Methodology Training
- March 2008 (28-29) Organization team member of the First International Conference on Management and Economics in Albania.
- November 2008(7-8) Organization team member of the First International Conference on Balkan Studies



## **Appendix: Questionnaire of the Survey**

Hello! My name is Besije Manushi I friendly request you to answer this questionnaire about UBA Islamic Banking here in Albania.

Purpose: The purpose of this questionnaire is to find out knowledge and opinion of people about Islamic banking system in Albania. It will help me to estimate possibility of implementing Islamic banking system in Islamic and non Islamic countries.

Your response will help me to complete my Master thesis with statistical real information.

Thank you, in advance for your cooperation.

### 1. Your Gender

- Male
- Female

### 2. Your Age

- (15-30) Years
- (31-40) Years
- (41-50) Years
- Above 51 Years.

### 3. Your educational qualification

- Primary
- Secondary
- Bachelor
- Master
- Another

4. Your profession

- Student
- Employee
- Businessman
- Unemployed
- Another

5. Is your religion Islam?

- Yes
- No

6. Have you ever heard about Islamic Bank?

- Yes
- No

7. Islamic bank do not involve in Riba (Interest), and instead of it use the method of profit loss sharing (partnership). Do you think is it better than western banking?

- Yes
- No
- Another

8. Islamic bank do not invest in industries with products and services involved (Alcohol, Pork and Gambling). Do you think is it OK, for welfare of society?

- Yes
- No
- I don't know
- Another

9. Is there any Islamic bank in your country?

- Yes
- NO
- I don't know

10. If yes. Do you use its services and products?

- Yes
- No

11. Which kind of banking system do you prefer?

- Islamic bank
- Conventional (western) bank
- Both of them

12.If you chose Islamic bank, what is the most important reason that attracts you to use Islamic banking system?

- Religion
- Good for welfare of society
- A and B
- Another

13. Do you work with others banks?

- YES
- NO
- OTHER

14. Will you use Islamic bank in future?

- YES
- NO
- I don't know

15. What s the most important reason that attracts you to use it?

- Low risk
- New product
- Good prospects of Islamic economic future
- Confidence problem
- Diversification
- Others

16. Which product(s) you are interested in?

- Bai I Bithaman Ajil( Deferred Payment Fianancing
- Ijara ( Lease Financing)
- Mudaraba ( Saving account)
- Murabaha ( Debt financing , Bank loan)
- Musharaka ( Equity financing)
- Sukuk ( Bond)
- Others

17. Do you think that ALBANIA is a suitable place to implement Islamic bank?

- YES
- NO
- I Don't know

