

Islamic Banking

by Mohamed Abdelhamid

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Department of Economics
Carleton University

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Islamic Banking

1. Introduction

Economies all over the globe are experiencing an increased rate of development, and financial institutions are a vital instrument for the continuity of this development. When people use the term financial institutions, they are most likely referring to banks. This is simply a consequence of the wide use of the banking system in our everyday lives. For both developed and developing economies, an efficient banking system is critical and one of the most pivotal elements of modern financial systems. The functions of financial systems are common, whether in Islamic or typical western economies. Similarly, the practical problems encountered in performing these functions are also common to all financial systems.

There are several important roles performed by financial systems that we should be familiar with. First, they act as financial intermediaries, channeling funds from savers to borrowers and in the process removing budget constraints that limit individuals and businesses. The system also offers a wide range of other financial services not directly related to financial intermediation such as fund management, insurance, payment services, and so on. Financial systems also create incentives for an efficient distribution of resources within an economy, and the allocation of limited financial and real resources between competing ends.

The financial systems also create a large range of assets and liabilities, which have a variety of characteristics such as their maturity, liquidity and risk involved.¹

Banks provide an intermediation function between agents with a surplus of resources and agents with a deficit of resources and as a result, facilitating the transfer and, thus hasten the pace of development. This is done through the banks' supply of credit and loanable funds to entrepreneurs and corporations that initiate investments and implement business ideas. Two major types of banks exist, western banks, or what we will call conventional banks, which rely on interest rates for the majority of its operations, and Islamic banks, which offer comparable services but conduct their operations in a completely different manner.

1.1 Emergence of Islamic banking

Although modern Islamic banking is considered to be a recent development, Muslims were able to access financial systems operating without interest since the beginning of Islamic history. The system was used to organize resources, finance productive activities and meet consumer needs. This system has proven to be quite effective during the development of Islamic civilization. For example, the GNP of the Abbasid Empire, which is the Arab family that descended from the prophet Mohammed's (peace be upon him) uncle, was the biggest on the planet at that time. The history of Islamic economics goes back to the Holy Qur'an and the *Sunnah*.² The action and approval of the Prophet were later put in writing by his followers and transmitted to others as the "hadith" of Prophet Muhammad (peace be upon him) more than 1,400 years ago. However, as economic activity shifted more towards the

¹ Munawar Iqbal and David T. Llewellyn, Islamic banking and finance: new perspectives on profit-sharing and risk, Cheltenham: Edward Elgar. 2002

² Sunnah: The title given to the collection of recorded words and actions of the prophet Muhammad (peace be upon him). Most of what he said or did throughout his lifetime is recorded in the Sunnah.

western world, the features of Islamic finance remained un-developed while Western financial institutions prevailed.

Over the past few decades there has been an increasing demand for the development and modernization of the Islamic financial system that existed in the past. The occurrence of this revival seems to be due to the intense desire of Muslims to stay away from interest-based finance, which is prohibited under Islamic law, also known as *Sharia'a*.

1.2 History of Islamic banking

There have been 3 key attempts to establish modern Islamic financial institutions over the past century. The first Islamic bank was found in Pakistan in the 1950s. Loans were offered to clients without interest, but minimal charges were imposed to cover the operational expenses of the bank. This experience gave some confidence to the system, but its failure was unavoidable due to two main reasons. First, the deposits made in the bank were to be held for a long time, and the depositors, who were mostly landlords, found that with the increasing number of borrowers, the gap between the amount of capital available and that of the credit requested had become too large. Secondly, the depositors showed considerable interest in the way their money was lent out, but the bank staff did not have complete autonomy over the bank's operations and could not always satisfy customers in this regard.³

The second attempt to establish a successful Islamic bank was led in Egypt, by Ahmed El Najjar in Mit-Ghamr, between 1963 and 1967. The institution took the form of a savings bank that operated on the basis of profit sharing. This experiment took place under-

³Muzahidul Islam, <http://banglapedia.search.com.bd/HT/I_0113.htm>

cover to avoid providing a religious image to the public, which might have influenced its progress. At the time of the establishment of that institution, Islamic fundamentalism was at odds with the political regime in power, and consequently, the project experienced many obstacles. Towards the end of this experiment in 1967, there were nine similar banks established in the country. By 1971, the institution was re-created under the name Nasr Social Bank. It was described as an interest-free bank although there was no indication in its charter that it was an Islamic bank guided by *Sharia*'a. The Nasr Social bank later became the first Islamic Bank based in Cairo, Egypt.⁴

Around the same time in Malaysia in 1963, another Islamic financial institution was created, called the Muslim Pilgrims Savings Corporation. The function of this institution was to assist people in saving for the Hajj (Pilgrimage) to Mecca and Madina, Saudi Arabia. Six years later, this institution developed into what is now known as the Pilgrims Management and Fund Board, or the Tabung Haji. Although it is a non-bank financial institution with a limited role, the Pilgrims Management and Fund Board's success helped pave the way for the Bank Islam Malaysia Berhad (BIMB), which is now the chief commercial Islamic bank in Malaysia.

In the 1970s, a few major events took place acting as pillars for the continuation of Islamic financial systems. The Islamic Development Bank was created by Muslim countries from all over the world to support the economic development of Muslim nations whilst complying with Islamic law. It was the first international development assistance agency to provide loans on an interest-free basis, thus complying with Islamic law. The Dubai Islamic Bank was also formed during that time. In 1977, the Faisal Islamic Bank of Sudan was created, as well as the Faisal Islamic Bank of Egypt. As well, the first attempt to establish an

⁴ Evolution of Islamic Banking, <http://www.islamibankbd.com/page/ih_1.htm>

Islamic bank in the western world also occurred in the 1970s: The Islamic Finance House was established in Luxembourg in 1978.⁵

Several Islamic countries have attempted the complete Islamization of their financial system. These countries include Iran, Pakistan and Sudan, which acts as targets for much research on Islamic financial systems. However, a lot of other countries have established Islamic banks in conjunction with 'conventional' banks. These countries include Malaysia, Indonesia, Bangladesh, Jordan and Egypt. Even in countries where the legal system doesn't allow the establishment of Islamic banks, such as India, Muslims have found alternative methods within the law to substitute interest-based financial institutions so as to carry out their financial needs while abiding by the *Sharia'a*.

Nowadays, the Islamic financial industry is one of the fastest growing industries in the world, and there are over 200 Islamic financial institutions operating around the globe under a variety of societal and economic conditions. These banks operate in 45 different countries encompassing most of the Muslim world. In 1997, it was estimated that the total market value of all Islamic financial transactions was about \$160 billion with a 10-15 per cent annual increase. Currently, Islamic Finance across the globe consists of \$300 billion in assets and 275 institutions that operate in 80 countries.⁶ Large Western multinational banks such as Citibank, HSBC, Barkley's and Merrill Lynch have recently begun offering Islamic modes of financing to diversify their large client base, which implies that the Islamic banking system is becoming increasingly accepted. This has also made the Islamic banking system much more challenging. In addition, Dow Jones has also introduced the Dow Jones Islamic Market index (DJIM) of 600 companies worldwide that comply with *Sharia'a* law. The

⁵ Tarek S. Zaher and M. Kabir Hassan, "Comparative Literature Survey of Islamic Finance and Banking" Financial Markets, Institutions & Instruments, Vol 10, Issue 4 (November 2001)

⁶The International Islamic Forum, <<http://www.iiff.net/index.cfm/page/content/contentid/118/menuid/111>>

progress of the past few decades proves that Islamic finance is here to stay, and is not just a passing phenomenon.⁷

Islamic banks have showed immense progress in a very short period of time, capturing a significant market share from their conventional rivals. Indeed, Islamic banks have exhibited incredibly high penetration rates in Muslim countries over the past 50 years. In Malaysia, Islamic banks captured 5% of the market, in Saudi Arabia, 12%, and in Kuwait, 30%. In 8-10 years, the predicted market share that will be managed by Islamic financial institutions is expected to be 40-50% of the total savings of Muslims worldwide. It is also important to note that Islamic Banks target only the local markets in which they operate and do not get involved in international markets, as do multinational western institutions such as Merrill Lynch.⁸

⁷ “Beyond Interest-Free Banking”, U.A.E Banking Review Business Intelligence for Decision Makers, Vol.VI, no.4 (June-July 2005)

⁸ Tarek S. Zaher and M. Kabir Hassan, “Comparative Literature Survey of Islamic Finance and Banking” Financial Markets, Institutions & Instruments. Vol 10, Issue 4 (November 2001)

Table 1: Worldwide Assets of the Islamic Financial System

| In \$ bn. | 1999 | 2000 | 2001 |
|--------------------------|-------------|-------------|-------------|
| Paid-up Capital | 6,917,274 | 10,556,986 | 12,596,556 |
| Reserves | 1,754,768 | 1,979,667 | 2,275,295 |
| Net Profit | 1,101,499 | 2,338,521 | 1,883,135 |
| Total Assets | 163,048,356 | 226,029,015 | 256,648,907 |
| Deposits | 116,298,419 | 176,162,898 | 197,477,938 |
| Total Investments | 91,336,106 | 114,852,296 | 155,424,175 |

- 2005 Total Asset Size is estimated close to \$ 300 billion (from \$ 140 bn in 1998)
- Consistent High Growth over 10 % per annum
- Assets concentrated in Gulf Countries, Middle East and North Africa at large⁹

⁹ Wafik Grais, "A significant and Growing Industry", World Bank Publications

1.3 Goals of Islamic Banking

The first and most important target of an Islamic bank is to serve God. In other words, the Islamic financial institution: “must develop a distinctive corporate culture, the main purpose of which is to create a collective morality and spirituality which, when combined with the production of goods and services, sustains the growth and advancement of the Islamic way of life”¹⁰ And similarly, to Quote Janahi (1995), “Islamic banks have a major responsibility to shoulder ...all the staff of such banks and customers dealing with them must be reformed Islamically and act within the framework of an Islamic formula, so that any person approaching an Islamic bank should be given the impression that he is entering a sacred place to perform a religious ritual.”¹¹ Thus, the religious is intertwined with the financial.

Another core focus of Islamic banking in the modern world is to encourage and develop the application of Islamic principles and law (Sharia'a) to transactions of finance, banking and business affairs. This also controls the engagement of investment companies in activities that are tolerable and consistent with the Sharia'a law thus preventing the occurrence of activities forbidden by Islam. The Banking system should, like all other aspects of the Islamic way of life, contribute to the reaching of the major socio-economic goals of Islam. While conventional finance focuses solely on economic transactions and markets, Islamic finance stresses the ethical, social and moral dimension of wealth creation, with a view to enhancing equality and fairness for the society as a whole. Concepts such as

¹⁰ Nasser M. Suleiman, Corporate Governance In Islamic Banks, (December 2000)

¹¹ A.L.Janahi, Islamic Banking, Concept, Practice and Future, 2nd edition. Manama: Bahrain Islamic Bank

economic justice, wealth distribution, social welfare and ethical behavior are the pillars of the Islamic financial sector.¹² For example, the prohibition of interest and the emergence of a profit-loss sharing regime may increase the volume of investments which in turn creates more jobs and hence, reduces unemployment in the society. This regime may also satisfy the social responsibility of a Bank or Islamic financial institution towards the weak and the poor by maintaining social funds. Islamic banks are required to collect 2.5 percent of the clients' assets, which have not been used throughout the period of one year. This is called the *Zakat*. Moreover, to satisfy the social justice from an Islamic perspective, Muslims should also donate money whenever they are capable of doing that. This is called a *Saddaqah* and is not mandatory like *Zakat* but is preferred. Thus it is a responsibility of an Islamic bank or financial institution to maintain social funds such as to collect, organize and distribute the money fairly to the poor and needy.

2. Sharia'a

2.1 Definition of Sharia'a

The ideology of an Islamic bank is based on the Islamic faith and must stay within the limits of *Sharia'a* in all of its actions. The Arabic word *Sharia'a* means 'the way to the source of life' and is now a familiar term to Muslims and non-Muslims. *Sharia'a* governs all aspects of a Muslim's life and comes from a combination of sources including the Qur'an,

¹² "Why Islamic Banking?" Association of Islamic Banking Malaysia, Accessed on 3rd June 2005
<http://www.aibim.com.my/aibim/dsp_page.cfm?pageid=230>

the Muslim holy book, the Hadis, which are the sayings of the prophet Mohammed, and Fatwas, which are the rulings of Islamic scholars.

A number of people, Muslims included, often misunderstand the purpose of *Sharia'a*. It is often associated with the amputation of limbs, death by stoning, lashes and other medieval punishments. As a result of this, it might be thought of as draconian. In the West, the *Sharia'a* is viewed as an archaic social system that subjugates societies that live under its rule. However, Muslims in general hold a different view; in the Islamic tradition, *Sharia'a* is seen as something that nurtures humanity. They see the *Sharia'a* not in the light of something primitive but as something divinely revealed. In a society where social problems are prevalent, *Sharia'a* is the code of conduct by which Muslims should abide. Iqbal writes that “*Sharia'a* provides a blueprint of how a society is to be organized and the affairs of its members conducted.”¹³

2.2 The 5 Rules of Sharia'a

There are 5 principle rules that govern investment behaviour in *Sharia'a*. The first, and most important, rule is the absence of interest-based (*Riba*) transactions. The Holy Qur'an prohibits the charging of *Riba* and the payment of it, and as a result, investors receive their returns by other means. Technically, *Riba* refers to the addition in the amount of the principal of a loan according to the time for which it is loaned with the amount of the loan. Previously, there was a question as to whether *Riba* relates to interest or usury, but there now seems to be a general agreement among Islamic scholars that the term refers to all forms of

¹³ Zubair Iqbal, and Abbas Mirakhor, “Islamic Banking,” Occasional Paper International Monetary Fund . No.49 (March 1987)

interest. In the prohibition of *Riba*, Islam seeks to develop an environment based on fairness and justice. A loan provides a fixed return to the lender regardless of the outcome of the borrower's course of action. From an Islamic point of view, it is much fairer to share in the profits and the losses. The idea of fairness in this situation has more than one dimension. The supplier of capital has the right to a return, but this return should be equivalent to the risk and effort involved in the project for which the finances are supplied. Therefore, the *Sharia'a* prohibits not fixed returns but predetermined returns.

The second important rule that governs investment behaviour is *the banning of financial transactions involving elements of speculation*. This refers to purchasing goods and services at a low price and selling them for a higher price in the future. Similarly, immediate sales to prevent future losses are also prohibited. This is due to the fact that speculators generate their profits at the expense of the society at large. Thus, "Whenever a commodity is speculated upon, a specific rate of interest would emerge. With the abolishment of interest, speculative motive of the demand for money, logically derived from interest, would disappear. Speculation, which necessary entails artificial risk in any market, be it in money, bonds, gold, commodities and the like, is not permissible in an Islamic setting."¹⁴

The third major principle discussed in the *Sharia'a* is *amanat*, meaning accountability. All Muslims are accountable for their actions and what they have achieved. Based on this principle, Islamic banks hold funds to help allocate and distribute them in the best possible ways. This also implies that the management of an Islamic bank will not only be responsible for their activities to the system but also to God.

The fourth rule that governs Muslim investors is *the mandatory payment of Islamic tax, Zakat*. The term 'Zakat' is derived from the Arabic word meaning pure. This tax is one

¹⁴ Iraj Toutouchian, The Role of Central Banks in Islamic Banking,

of the five basic tenets of Islam, and is equivalent to 2.5 percent of a Muslim's annual income. It is seen as a method for the redistribution of income and wealth among a society to provide equality and a fair standard of living. Every Islamic bank thus has to establish a Zakat fund for collecting the tax from investors and depositors and distributing it to the poor directly or through other religious entities.

The fifth rule is that the *financing of business activities that are forbidden by Islam is prohibited in Islamic banking*. This includes the farming of pork, for example, or the trade in alcohol. The production of goods and services that are necessary for the economy is the priority. The needs of the community must be satisfied prior to the involvement in other activities. In order to ensure that the bank is in strict conformity with Islamic law, an extra layer of governance is added. This could be an individual *Sharia'a* advisor or board of scholars. We will discuss the management and the supervision of Islamic banks thoroughly later in the essay.¹⁵ As well, there is a huge debate between Muslim scholars regarding the applicability of *Sharia'a* law in the financial field. As Wilson states, "Although the law itself is clear, its translation into modern, rapidly evolving financial practice is inevitably open to different interpretations."¹⁶

¹⁵ Nasser M. Suleiman, Corporate Governance In Islamic Banks, (December 2000)

¹⁶ Rodney Wilson, ed. Islamic financial markets. P 12, London; New York: Routledge, 1990

3. The Meaning of Riba and Interest

There has been an assumption by Islamic scholars that the prohibition of interest is unique to Islamic literature. In fact, its advocacy has been a feature of both religious teachings and nonreligious literature over several decades. This section proceeds by discussing the major arguments against interest in the western, as well as Islamic, literature. In reality, there is little in contemporary economic literature, which is fundamentally not in favour of interest payments; it is thus the religious and moral considerations that lie at the root of the opposition.

3.1 The Western View of Interest

Many economists have attempted to use the divergence between the natural and the market rate of interest to explain the cyclical fluctuations in the economy. For example, Dar and Presley write that, “Economists of many persuasions in Western literature have identified linkages between interest rates and the kinds of macro-economic instabilities which afflict most capitalist economies – inflation, unemployment, negative growth.”¹⁷ The natural rate of interest has been classically defined as the rate that leads to an inequality in savings and investment, which results in an equilibrium level of income in the long run. Dar and Presley also write that, “The difference between market and natural rates of interest is that the former is determined by monetary forces in the loanable funds market, for example, money supply growth and bank credit creation, and the natural rate

¹⁷ Humayon A. Dar and John R. Presley, “Islamic Finance: A Western perspective,” International Journal of Islamic Financial Services. Vol. 1 No. 1 (April-June 1999)

is determined by the profitability of investment.”¹⁸ Many economists suggest that, cyclical fluctuations occur when both rates are not equal over time.

Many great economists such as John Stuart Mill and Adam Smith agreed that in the long run changes in the quantity of money supply reflect changes in price but do not have an effect on interest rates because they do not influence the rate of profit. On the other hand, classical writers felt that monetary forces can influence the market rate of interest in the short run. Economists that recognized the force saving doctrine, that states that banking operations could cause a difference between both rates of interest in the short run. The rate of profit resulting from the employment of capital regulates the rate of interest and not the volume of bank loans.

Other economists had a different view. They suggested that the divergence between the natural and market rate of interest is linked to newly created money. This newly created money results in the anticipation of an increased profit from investments due to the expansion it causes. Subsequently, the demand and supply of loanable funds increases without an equal increase in the market rate of interest. The result is that aggregate investment in the economy becomes greater than voluntary savings. As the expansion process continues, the economy witnesses an increase in the demand for goods, which may lead to an increase in withdrawals from banks. This in return will cause an increase in the market rate of interest, which has an adverse effect on projects that have already begun, and leaves them unprofitable.

More recently, many economists such as Minsky, Greenwald and Stiglitz, have all developed theories that give interest rates a chief role in the explanation of cyclical

¹⁸ Ibid.

fluctuations in the economy. As Dar and Presley write, “In essence, therefore, there is almost a 'tradition' in Western economic literature, which blames interest rates and associated bank credit expansions and contractions for many of the economic evils of our time.”¹⁹

3.2 The Islamic View of Interest

Although the nonexistence of interest in Islamic financial systems is a fundamental feature, it is by no means their only characteristic. It depicts only one dimension of their broad, multifaceted nature. The prohibition to pay and receive interest defines the essence of the Islamic financial system, but it is supplemented by other principles of Islamic doctrine, which advocates risk-sharing, individual and property rights, and the sanctity of contracts. It is imperative to look at all Islamic teachings and *Sharia*'s characteristics and not focus on only one or a few aspects in this paper.

It is said in Islamic law that interest was a tool to manipulate people by making the rich become richer and the poor become poorer. Rich people also exerted less effort due to the fact that they have a guaranteed return with no involvement in risky transactions and that was considered an injustice. The Arabic word, *Riba*, technically means growth, addition, expansion or increase. However, from an economic perspective, it refers to the contractual increase on loans and commodities.

There have been so many explanations and interpretations of *Riba*; however, they can be summarized under three main titles: liberal, mainstream and conservative. The liberal view seems to equate *Riba* with usury, which is an excessive rate of interest

¹⁹ Ibid.

compounded at short intervals of time. The interest rates charged by many financial institutions do not lie in within the boundaries of this definition and thus are not considered *Riba*. The mainstream view states that any contractual increase is *Riba*. As a result, all bank interest lies within the definition and is prohibited. The conservative view sets a larger boundary for the definition of *Riba*, which includes “all forms of economic exploitation of the poor by the rich like profiteering and the paying of subsistence wages to laborers.”²⁰

There are several verses in the Qur’an illustrating the prohibition of usury. To quote the Qur’an, “*Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: Trade is like interest. While God has permitted trade and forbidden interest. Hence those who have received admonition from their Lord and desist, may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitance of the fire and abide therein for ever.*”²¹ Further, in verse 278 of the same Surah, the Qur’an states, “*O ye who believe! Fear God, and give up what remains of your demand for usury, if ye are indeed believers*”.²² Another verse of the Qur’an that also reveals the prohibition of usury says, “*That they took usury, though they were forbidden; and that they devoured men’s substance wrongfully; we have prepared for those among them who reject faith a grievous punishment.*”²³ However, not every addition to or increase in the principal amount transacted is prohibited in Islam. One example is the addition to the principle amount that must be paid for an extension in a loan’s maturity date.

²⁰ Muhammad Mazhar Iqbal, “A Broader definition of *Riba*” Accessed on 8th July 2005
<http://www.pide.org.pk/psde/Papers_18AGM.html>

²¹ Qur’an: Surah al-Baqarah, verse 275.

²² Ibid, verse 278.

²³ Qur’an: Surah Ali Imran, verse 161.

Money, from an Islamic point of view, is not capital. It is a medium of exchange or a store of value. Money has no fundamental use. It cannot be utilized for fulfilling human needs directly. It can only be used for acquiring goods or services, which have a fundamental use. Managerial and entrepreneurial skills along with the productive use of money are the essential factors in converting it into capital. The lenders of the money have no input in the conversion process and thus, they do not deserve a reward. Under Islamic law, restraining oneself from spending and consumption, in other words saving, should not be rewarded by an increase in capital.²⁴

Great emphasis is placed in Islam on the distinction between trade and *Riba*. On one hand, the risk involved in trading is evenly distributed among all parties involved. On the other hand, the engagement in *Riba* results in borrowers taking all the risk upon themselves. It is also a myth that Islamic financial systems discourage profit. On the contrary, profits are the result of successful entrepreneurship and the creation of wealth, risk-sharing and a contribution to social welfare. Some might argue that lenders partake in risk by taking their chances as to whether the borrower will return their money or not. It is clear that such a risk taken is one of creditworthiness and moral solidness, and moreover, it does not involve any risk in the success or failure of the enterprise in which the funds were occupied. The lender who chooses to invest his funds in trade and production automatically becomes a shareholder and not a creditor. By definition, a shareholder in a business is liable for his debt to the extent of his investment. If the project fails, in which shareholder has invested, he or she shares the losses. And if the project is a success, generating profits, the shareholder is entitled to a share of those

²⁴ Zubair Iqbal, and Abbas Mirakhor, "Islamic Banking," Occasional Paper International Monetary Fund . No.49 (March 1987)

profits. In theory, if not always in actual practice, this makes the suppliers of funds for Islamic financial institutions investors all the time.

4. Islamic Banking from two perspectives

The Islamic financial system is not limited to banking, but covers also financial instruments, financial markets, and all types of financial intermediation. In any functioning economy, there are two levels that must be considered when addressing any issue. The two levels we will focus on are the micro- and macro-economic aspects of interest in Islamic Finance.

The macro-economic aspect focuses on the study of the economy on the aggregate level, tackling such concepts as income, output, the level of employment of productive resources, the general behaviour of prices and the interrelationship among diverse economic sectors. In this paper, when we refer to the macro-economic perspective, we are interested in one main aspect, namely, the activities of the central bank with respect to monetary policy, the relationship between the central bank and other local banks and the transactions that occur between central banks and the World Bank with respect to borrowing, lending and debt.

4.1 The macro-economic perspective & Islamic banking

To discuss the macro-economic aspect of Islamic banking we must focus our attention on the activities of the central bank. This is because the central bank is the heart of any macro-economic policy and it is a government's main instrument for managing the economy.

There are two primary methods to finance a government deficit. The first method is by issuing additional government bonds and securities, and the second method is by printing additional money. This choice between borrowing from the public and the creation of money is made by the central bank. If the bank chooses to create money to finance the deficit, it issues 'fiat money' that acquires the status of high-powered money. Fiat money is not backed up by any commodities such as gold or silver but is legally accepted by law in all transactions. Theoretically, the increase of money supply in the economy due to additional fiat money results in an increase in aggregate demand for goods and services, which triggers an increase in output and prices. How the increased demand influences the change in output and growth depends on the elasticity of the supply of goods and services being produced. If the supply is elastic, then the increase in money supply turns into an increase in output. If the supply of goods and services is completely inelastic, the increase in money supply turns into equivalent inflation.²⁵

The quantity theory of money provides a link between money supply, price level, aggregate output and the velocity of money. It can be stated as follows:

$$M \times V = P \times Y$$

where M is the quantity of money supply,

V is the velocity of circulation,

P is the price level, and

Y is aggregate output in the economy.

By taking growth into account, the equation for the quantity theory of money can be re-written as:

²⁵ Muhammad Anwar, "Islam city of Banking and modes of Islamic banking," Proffesorial Inaugural Series (31st October 2000)

$$\hat{M} \times \hat{V} = \hat{P} \times \hat{Y}$$

This equation shows that, as the central bank increases the supply of money in the economy by issuing fiat money, this increase is reflected in the three other factors of the equation. If we assume the velocity of money circulation in the economy is constant, then the growth in money supply will be translated into inflation and growth in output. As we mentioned earlier, depending on the elasticity of supply of goods and services, the growth may be translated into output only and this increased output is transferred to the central bank.²⁶

On the other hand, if the increase in the money supply caused by the creation of fiat money is translated into an increase in the price level due to the inelastic supply of goods and services, it creates what we know as inflation tax or seignorage. Seignorage is defined as “the revenue the government gets from printing money.”²⁷ In other words, it represents the transfer of ownership from the holders of money to the creators of money, in this case the central bank.²⁸ This transfer of property from the public to the government without the public’s consent is considered unfair and unjust from an Islamic perspective. To quote the Qur’an, “Do not eat up your property among yourselves by foul means nor channel it to the authorities...wrongfully and knowingly.”²⁹ It is clear why Islamic law prohibits the process of creation of fiat money, which is not backed up by commodities such as gold or silver reserves. Since this creation of money is an essential tool used by the central bank to finance

²⁶Frederic S. Mishkin and Apostolos Serletis, The Economics of Money, Banking and Financial Markets, 2nd Canadian Edition, p509

²⁷ David Romer, Advanced Macroeconomics, (2nd Edition), 468-469.

²⁸ Muhammad Anwar, “Islam city of Banking and modes of Islamic banking,” Proffesorial Inaugural Series (31st October 2000)

²⁹ Qur’an: Surah Al-Baqarah, verse 188

its deficits and stabilize the economy, the institution of central banking needs further development from an Islamic viewpoint in order for it to comply with *Sharia*'a law.

The other method used by central banks to finance government deficit is by borrowing money from commercial banks in times of need. The central bank issues bonds and securities, which work on the basis of interest. As the government tries to service its debts, the process leads to an increase in budget deficits and leads to further borrowing from the banking system or the issuance of more high-powered money. Therefore, not only do central banks engage in activities that violate Islamic principles, they are responsible for passing on the unlawful growth to commercial banks as well.³⁰ The process by which this transfer occurs is described in more detail below.

The money creation process is initiated by commercial banks as a consequence of the depositing and lending of high-powered money. The mathematical expression for the money creation process is:

$$D = H/r$$

where D is the amount of deposits, which become the money supply in the economy, H is the amount of high-powered money, and r is the reserve holding ratio of commercial banks.

In order for commercial banks to increase the money supply in the economy using high-powered money, four conditions must be satisfied. First, any individual in the economy receiving cash or cheques must deposit them back into the banking system. Secondly, all bank deposits must be accepted as means of payment. The third necessary condition is that

³⁰ Muhammad Anwar, "Islam city of Banking and modes of Islamic banking," Proffesorial Inaugural Series (31st October 2000)

banks must hold a fraction of its reserves in the form of cash, and finally, the public must be willing to borrow the whole amount the banks are offering to lend.³¹

The reserve holding ratio of commercial banks determines the increase in the quantity of money supplied. The reserve ratio and the money supply are inversely related. Thus, the lower the reserve ratio, the higher the money supply, and vice versa. The increase in the money supplied becomes the property of the commercial banks holding the deposits of the public. Again, this is not accepted under Islamic law and contravenes the verse from the Qur'an which states, "do not devour your properties among yourselves through false means."³² As well, as mentioned earlier, the expansion of the money supply in the economy by banks causes inflation and a destabilization of the economy. In turn, this inflation causes the real value of the deposits to fall. It also creates wealth for commercial banks to the extent of the seignorage created, but without parallel delivery against it. This shrinkage of the value of the deposits made by the public due to the expansion of the money supply is in clear breach of Islamic principles. The direct money creation by the central bank is only advantageous for the government, and similarly, the indirect money creation activities through deposits by commercial banks are also only beneficial for the commercial banks.

Islamic scholars, economists and other supporters of the Islamic banking system overlooked a very vital issue, which is the validity of the banking system itself. The spotlight was diverted to the soundness of the interest-based transactions between banks and their clients on the microeconomic level, rather than focusing on the system as a whole. Further amendments must occur before this could be regarded as a complete Islamic financial system. In order to enhance the Islamization of the banking system from a macroeconomic

³¹ Ibid.

³² Qur'an: Surah Al-Baqarah, verse 188.

perspective, the two banking activities mentioned earlier require specific attention: the creation of fiat money by the central bank to finance government deficits and the expansion of the money supply by commercial banks using tools such as the reserve holding ratio.

The central banks in the west traditionally stand behind the banking system by offering liquidity to banks in case of a shortage of funds in the system. However, the *Sharia'a* prevents the central banks from controlling or giving support to Islamic banks if a liquidity gap should occur, thus Islamic banks are deprived from enjoying such an advantage and are excluded from the lender of last resort function because of interest payments due on loans.³³

The acknowledgement of the above-mentioned contradictions with Islamic principles from a macroeconomic perspective has caused some Muslim economists to suggest some solutions. Professor Dr. Muhammad Anwar of the University Of Malaysia suggested that the central bank should replace fiat money with commodity money, which is backed up by gold or silver. From his point of view, this will abolish the seignorage creation by the central bank. Another solution for this problem would be to utilize the money created from seignorage by issuing return-free loans. Since Islamic finance focuses on the social aspect as well, the return-free loans could be directed at needy people or state organizations for the development of social projects to improve the living standards for the society as a whole. Given that this seignorage has been taken out from the society, it is a property of the society as a whole and should be used for development rather than enriching commercial banks. Dr. Muhammad

³³ Tarek S. Zaher and M. Kabir Hassan, "Comparative Literature Survey of Islamic Finance and Banking" Financial Markets, Institutions & Instruments. Vol 10, Issue 4 (November 2001)

Anwar wrote “Main idea of this proposal is to transform the seignorage into a form of *Saddaqah* so that what is extracted from the society is spent on the society.”³⁴

In order to eliminate the expansion of money supply by commercial banks, other writers suggest a 100% reserve ratio holding, which would eliminate seignorage generated by commercial banks. Although this seems like an appropriate solution from one angle, it has negative consequences from another. By imposing a 100% reserve ratio holding by banks, the money creation activities will be abolished and the hoarding of the deposits will prevail. Islam prohibits the hoarding of funds; thus, what appears to be the solution to one problem would end up creating another.

Islamic banks certainly face many challenges today, due to the fact that we live in an economy that is structured and driven by interest. Due to the complexity of the situation and the difficulty that arises in trying to amend an existing structure, many people have suggested a complete reformation of the existing commercial banking system. Such a proposal, in my opinion, is unfeasible at this time, given the amount of dependence on the current system.

4.2 The micro-economic perspective

Microeconomics, on which we shall centre our attention in this section, is the study of the economic behaviour of individual consumers, households, firms and industries, and the distribution and production of income among them. Here, when we refer to the micro-economic perspective in Islamic banking, we are interested in the operations that occur on an individual bank level, such as the instruments and services that banks offer to their clients.

³⁴ Muhammad Anwar, “Islam city of Banking and modes of Islamic banking,” Proffesorial Inaugural Series (31st October 2000)

4.2.1 Introduction to modes of financing

We are familiar with the concept of interest used in conventional banking systems to provide financial services for both assets and the liabilities. Since *Sharia'a* law prohibits interest-based financing, several modes of financing have been developed by Islamic financial institutions to allow for the channeling of borrowing and savings between the public and entrepreneurs such that investment opportunities emerge and increase. The underlying concept for each technique is simple and can be compared to an existing conventional financial instrument. Although the degree of use of one specific mode varies from one country to another, and among individual banks, the basic principles behind these modes are all similar. Islamic banks have recognized the need to supply financial services such as insurance, fund management and payment services and thus they have developed contracts to match those needs accordingly.

However, actual financial deals may become very complex due to the modification of the structure of these financial modes to fit the specifications of investors. Thus, they are likely to contain a combination of contracts or elements of contracts. This section describes the variety of modes provided by Islamic banks all over the world and identifies the unique characteristics that make them distinctive from one another.³⁵

To make things clearer, the services and modes of financing offered by Islamic banks will be divided into three sections as follows. The first section, on PLS accounts, discusses in detail the different kinds of deposit facilities offered by Islamic banks, such as demand deposits and investment deposits. The second section is called the PLS contracts

³⁵ Tarek S. Zaher and M. Kabir Hassan, "Comparative Literature Survey of Islamic Finance and Banking" Financial Markets, Institutions & Instruments, Vol 10, Issue 4 (November 2001)

section and will discuss in detail the two main profit-loss sharing facilities offered by Islamic banks, *Mudarabah* and *Musharakah*. The last section will describe other contracts and modes of financing offered by Islamic banks such as *Murabahah*, *Salam*, *Istisna* and *Ijarah*, which do not use profit-loss sharing schemes. We will call this section Non-PLS contracts.

4.2.2 PLS Accounts

On the deposit end, Islamic banks normally operate four broad categories of accounts: current, savings, investment and special investment accounts. The *current account*, as in the case of conventional banks, gives no return to the depositors. It is essentially a safekeeping arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time and permits the bank to use the depositors' money for liquidity purposes. As in the case of conventional banks, cheque books are issued to the current account holders, and Islamic banks also provide a broad range of related services, such as payment facilities, clearing mechanisms, bank drafts, bills of exchange, travellers cheques, etc. More often than not, the banks make no service charges in this regard. The reason to justify the capital value guarantee is the assumption that current accounts have been placed as *Amanat* (i.e., for safekeeping). Hence, they belong to depositors, and are accessible anytime.

Another type of deposit account is the *savings account*; here the bank has the discretion to periodically pay the depositors a positive return, depending on its own profitability. Such payments are considered lawful in Islam since they are not a condition for lending, nor are they predetermined. The savings account holders are issued with savings books and are allowed to withdraw their money as they please.

The *investment account* is based on the *Mudarabah* principle, which I will discuss in detail later. These deposits are term deposits, which cannot be withdrawn before they mature. The profit-sharing ratio varies from bank to bank and from time to time, depending on supply and demand conditions. The rate of return could be positive or negative, but in practice the returns are usually positive and quite comparable to the rates that conventional banks offer on their term deposits. Islamic banks always bear in mind that since investment accounts are based on the *Mudarabah* principle, there is always a chance that the rate of return could be negative. In that case, they should remove the loss incurred from the deposit account. Such a scenario would disrupt the system by decreasing the bank's credibility. To prevent that imbalance in the system, Islamic banks set aside part of their profit in a stabilization fund to compensate for losses so that depositors have a stable return.

Unlike regular investment accounts, holders of *special investment accounts* have the option to choose specific projects that they wish to invest their funds in. As a result, the funds in special investment accounts normally end up in large popular investment projects and institutions known for their solid credibility and high rates of return.³⁶

4.2.3 PLS Contracts

In the interest-free system recognized by Islam, people are able to earn a return on their money by subjecting themselves to the risk involved in profit-loss sharing (PLS). This is an arrangement where the rate of return on financial assets held in banks is not known and not fixed prior to the undertaking of the transaction. The actual rate of return can be determined only *ex post facto*, on the basis of actual profits accrued from real sector activities

³⁶ Nasser M. Suleiman, Corporate Governance In Islamic Banks, (December 2000)

that are made possible through the productive use of financial assets. Profit-loss sharing has been recognized as the core of Islamic banking. Most Islamic economists contend that PLS is based on two major modes of financing, namely *Mudarabah* and *Musharakah* which will be discussed in detail below.

4.2.3.1 Mudarabah

I. Definition of Mudarabah

The first contract we shall discuss is the *Mudarabah* contract, which is a form of partnership between two or more entities. The first party provides the funds, while the management and work is the exclusive responsibility of the second party. The financier is known as '*rabbul-mal*' and the entrepreneur as '*mudarib*'. Together they combine human and financial capital in order to set up a risky but profitable joint investment project. The main goal of such a contract is to use funds as well as to distribute returns to the investment according to *Sharia'a*, on the basis of profit and loss sharing.³⁷

II. Some basic rules of Mudarabah

The first party involved may specify a particular business for the second, in which case he shall invest the money in that particular business only; this is called restricted *Mudarabah*. Conversely, in unrestricted *Mudarabah*, the *mudarib* is authorized to invest money in any business he deems fit.

The provider of the funds can engage in *Mudarabah* with more than one person through a single transaction. This means that he offers money, for example, to two *mudaribs*,

³⁷ Abdel-Fattah A.A. Khalil, Colin Rickwood and Victor Murinde, "Evidence on agency-contractual problems in mudarabah financing operations by Islamic Banks," *Islamic banking and finance: new perspectives on profit-sharing and risk*, Cheltenham: Edward Elgar. 2002

so that each one of them can act for him as *mudarib* and the capital of *Mudarabah* will be utilized by them jointly, and the share of the *mudarib* shall be distributed among them according to the agreed proportion. In this case both the *mudaribs* shall run the business as if they were partners. The *mudarib* or *mudaribs*, as the case may be, are authorized to do anything, which is normally done in a course of business. However, if they want to do work that is beyond the normal routine of the traders, they cannot do so without expressed permission from *rabb-ul-mal*.

It is essential for the validity of a *Mudarabah* contract that the parties agree, from the beginning, on a fixed proportion of the actual profit to which each of them is entitled. *Sharia'a* law sets no particular proportion; rather, it is left that to the agreement of both parties. They can share profit in equal proportions, and they can also allocate different proportions for the *rabb-ul-mal* and *mudarib*. However, they cannot allocate a lump amount of profit for any party, nor can they determine the share of any party at a specific rate tied up with capital.

Aside from the agreed proportion of the profit or loss, the *mudarib* cannot claim any periodical salary or a fee or compensation for the work done for him by the *Mudarabah*. If the investment has earned a loss in some transactions but has gained a profit in others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

Either of the two parties involved can terminate the contract of *Mudarabah* at any time they wish. The only condition is that a notice must be given to the other party. If all assets of the *Mudarabah* are in cash form at the time of termination, and some profit has been earned on the principle amount, it shall be distributed between the parties according to the

agreed ratio. However, if the assets of the *Mudarabah* are not in cash form, the *mudarib* will be given an opportunity to sell or liquidate them, so that the actual profit may be determined.

There is a difference in opinion among the Muslim jurists about the question of whether the contract of *Mudarabah* can automatically restart after it terminates. It appears from the general principles that no such limit can be fixed, and each party is at liberty to terminate the contract whenever he wishes. This ability of both parties to terminate the *Mudarabah* contract when they please may create some difficulties in the context of the present circumstances. This is due to the fact that most of the commercial enterprises and investment projects today need time to bear fruit. Therefore, it may be disastrous to the project if one of the parties terminates the *Mudarabah* contract at the beginning of the venture. Specifically, it may be a severe setback to a *mudarib* who will earn nothing despite all his efforts. Therefore, if the parties agree, when entering into the *Mudarabah*, that no party shall terminate the contract during a specified period, except in specified circumstances. This does not violate any principle of *Sharia'a*, particularly in the light of the famous *hadith*, which says: “All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.”³⁸

4.2.3.2 Musharakah

I. Definition of Musharakah

The connotation of this term is a little more limited than the term “*Shirkah*,” which is more commonly used by Islamic scholars. *Shirkah* means ‘sharing,’ and under Islamic financial principles, this is divided into two kinds. The first kind is ‘*Shirkat-ul-milk*’ which

³⁸ Maulana Taqi Usmani, “Islamic Finance Musharakah & Mudarabah”, Accessed on 26th May 2005
<<http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.html>>

refers to the joint ownership of two or more persons of a particular property. This kind of *Shirkah* may exist in a variety of forms. Sometimes, it comes into operation at the option of the parties. For example, if two or more persons purchase equipment, it will be owned jointly by both of them. Here this relationship has come into existence at their option, as they themselves decided to purchase the equipment jointly. There are also other cases where this kind of *Shirkah* comes into operation without any action taken by the parties. For instance, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as an automatic consequence of the death of that person. The second kind of *Shirkah* is '*Shirkat-ul-‘aqd*' which literally means a partnership based on a mutual contract. For the purpose of brevity, this may also be translated as joint commercial enterprise.³⁹

In the framework of business and trade, *Musharakah* refers to a joint enterprise in which all the partners share the profit or loss of the joint venture. It is an ideal alternative to interest-based financing, with far reaching effects on both production and distribution. The return in a *Musharakah* contract is based on the actual profit earned by the joint venture. As well, while the financier in a regular interest-bearing loan cannot suffer loss, the financier in *Musharakah* can suffer loss.

II. Basic rules in a *Musharakah* Contract

In a *Musharakah* contract, each individual partner has a right to the management, unlike *Mudarabah*. However, in most cases, the parties agree that one of them is responsible

³⁹ Ibid.

for the management of the enterprise. Since risk is in the essence of a *Musharakah* contract, *Sharia*'a law has accepted it as one of the main PLS contracts in Islamic banking.⁴⁰

Islam has termed interest as an unjust instrument of financing because it results in injustice either to the creditor or to the debtor. If the debtor suffers a loss, it is unjust on the part of the creditor to claim a fixed rate of return; and if the debtor earns a very high rate of profit, it is unjust to the creditor to give him only a small proportion of the profit, leaving the rest for the debtor. In the modern economic system, it is the banks that advance depositors' money as loans to investors and traders. For instance, if investors want to initiate a project, and they only have a fraction of the required capital, then most of the project is funded by loans that are created from depositors' money. If this project generates a positive return, only a small proportion of it will go to the depositors through the bank, while the investors whose real contribution to the project was minimal, will gain all the rest. On the contrary, if in an extreme situation, the investors go insolvent, their loss is limited to the small fraction of their own capital, while the rest of the loss is borne by the bank, and in some cases, by the depositors. In this way, the rate of interest is the main cause for imbalances in the system of distribution, which has a constant tendency in favour of the rich and against the interests of the poor.⁴¹

According to Islamic principles, the intentions of a financier must be determined prior to his engagement in a *Musharakah* contract. If the financier is advancing a loan to the debtor for the sole purpose of assistance, he may not receive any excess on the principle of his loan.

⁴⁰ Hussain G. Rammal, "Financing Through Musharaka: Principles And Application" Accessed on 28th May 2005 <www.westga.edu/~bquest/2004/musharaka.htm+Hussain+G.+Rammal&hl=en>

⁴¹ Maulana Taqi Usmani, "Islamic Finance Musharakah & Mudarabah", Accessed on 4th June 2005 <<http://www.darulloomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.html>>

On the other hand, if he wants to share in the profits of his debtor, it is necessary that he also share the losses that may be incurred. Thus the returns of the financier in *Musharakah* are tied up with the actual profits accrued through the venture. The greater the profits generated, the higher the rate of return for the financier. If the venture earns enormous profits, the investor does not have the right to all of it but must share it with the depositors at the bank. In this way, *Musharakah* has a tendency to favour the common people rather than the rich only. This is why Islam has suggested *Musharakah* as an alternative to the interest-based financing.

In a similar manner to a *Mudarabah* contract, with *Musharakah*, both parties have the right to end the contract at any time as long as a notice is given to the other party involved. The assets may be liquidated prior to their distribution among the parties involved or the division could occur in asset format, depending on the preference of both parties.

Although *Musharakah* is not widely used as a mode of financing in comparison to other Islamic financial instruments, it is still considered to lie at the heart of Islamic financial principles and its use as a PLS contract is very much encouraged. *Musharakah* contracts play a huge role by ensuring investors that the financial institution is not providing any interest-bearing products.⁴²

4.2.4 Non-PLS Contracts

Where profit-loss sharing mechanisms cannot be used, Islamic banks provide other contracts and services that are legally binding and lawful under *Sharia'a* law and Islamic principles. There is a variety of non-pls modes of financing provided by different banks in

⁴² Hussain G. Rammal, "Financing Through Musharaka: Principles And Application" Accessed on 28th May 2005 <www.westga.edu/~bquest/2004/musharaka.htm+Hussain+G.+Rammal&hl=en>

different countries, but for convenience, I will discuss the four major non-pls contracts available in detail. These are *Murabahah*, *Salam*, *Istisna* and *Ijarah*.

4.2.4.1 *Murabahah*

I. Definition of *Murabahah*

When a seller declares the costs incurred in acquiring a commodity to be sold, in addition to a profit/mark-up to be mutually agreed with the buyer, this transaction is called *Murabahah*. The declared costs of acquiring the commodity include all costs incurred by the seller such as freight, handling, storage, custom, duty etc. The mark-up can be applied to the aggregate cost. However, recurring business expenses like staff salaries, rent, etc., cannot be included in the cost of an individual transaction. The profit claimed over the cost takes care of these expenses. If the exact cost of the commodity cannot be determined, the commodity cannot be sold according to *Murabahah*. In this case the commodity is sold on a bargaining basis.

Originally, *Murabahah* is a particular type of sale and not a mode of financing. According to *Sharia'a*, the ideal mode of financing is *Mudarabah* or *Musharakah*. However, there are some difficulties with these instruments in some areas of financing. Subject to certain conditions, *Sharia'a* experts have allowed the use of *Murabahah* on deferred payment basis as a mode of financing. There are two important points that are worth highlighting. First, it should never be overlooked that *Murabahah* is fundamentally not a mode of financing. It is only a device to escape from “interest” and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used only as a transitory step taken in the process of the Islamization of the economy, and its use

should be restricted only to those cases where *Musharakah* and *Mudarabah* are not practicable.

Secondly, *Murabahah* transactions do not come into existence by replacing the word “interest” with the words “profit” or “mark-up”. Actually, the *Sharia’a* scholars, with some exceptions, have allowed *Murabahah* as a mode of finance. Unless these conditions are fully observed, *Murabahah* is not permissible. In fact, it is the observance or non-observance of these conditions that draws a clear line between an interest-bearing loan and a *Murabahah* transaction. If these conditions are neglected, the transaction becomes invalid according to *Sharia’a*.⁴³

II. Basic rules of *Murabahah*

As we mentioned earlier, *Murabahah* is not a loan given on interest; it is a sale of a commodity for a deferred price, which includes an agreed upon profit added to the cost. Therefore, *Murabahah* cannot be used as a mode of financing except where the client needs funds to actually purchase some commodities. Another condition that must be satisfied in a *Murabahah* is that the financier must own the commodity before selling it to his client. The commodity must come into the possession of the financier, whether physical or constructive, in the sense that the commodity must be in his risk, though for a short period. This is the only feature of *Murabahah* that distinguishes it from an interest-based transaction. Therefore, it must be observed with due diligence at all costs, otherwise the *Murabahah* transaction becomes invalid according to *Sharia’a*.

⁴³ Maulana Taqi Usmani, “Islamic Finance Musharakah & Mudarabah”, Accessed on 4th June 2005
<<http://www.darulloomkhi.edu.pk/fiqh/islamicfinance/islamicfinance.html>>

It is also a necessary condition for the validity of *Murabahah* that the commodity is purchased from a third party. The purchase of the commodity from the client himself on buy-back agreement is not allowed in *Sharia'a*. Thus *Murabahah* based on a 'buy back' agreement is nothing more than an interest-based transaction.

In the case of buyer default at the due date, the price cannot be increased. However, if he has undertaken in agreement to pay an amount for a charitable purpose, he shall be liable to pay the amount undertaken by him. But the amount recovered from the buyer shall not form part of the income of the seller. He is bound to spend it on charitable purposes, on behalf of the buyer.⁴⁴

III. Some Basic Misconceptions in *Murabahah* Financing

After explaining the concept of *Murabahah* and its relevant issues, it is crucial to highlight some basic mistakes often committed by financial institutions in the practice and implementation of the concept.

Murabahah can only be used only where there is a commodity intended to be purchased by the customer. As a result, using *Murabahah* for financing the overhead expenses of a firm or company – such as paying salaries or electricity bills – is prohibited under *Sharia'a* law. It is the Islamic bank's duty to make sure that the client really intends to purchase a commodity, which may then be subject to *Murabahah*. Authorities providing the service to the customer must obtain this assurance.

Another mistake often committed by Islamic financial institutions is the selling of the commodity to the client before the commodity is actually acquired by the Islamic Institution

⁴⁴ Ibid.

from the supplier. This mistake is committed in transactions where all the documents of *Murabahah* are signed at one time without taking into account the various stages of the *Murabahah*.

Often Islamic financial institutions implement *Murabahah* financing on commodities that are already purchased by their clients from a third party. Once the client himself purchases the commodity, it cannot be purchased again from the same supplier. If the bank purchases it from the client himself, it is a buy-back technique, which is not allowed according to *Sharia'a*. In fact *Murabahah* can only take place on commodities not yet purchased by the client.⁴⁵

4.2.4.2 Salam

I. Definition of Salam

In order for a commodity to be sold while still abiding by *Sharia'a* law, three conditions must be satisfied. First, the existence of the commodity is necessary in order for a sale to be valid; thus, a commodity that does not exist at the time of sale cannot be sold. Second, in order for a sale to be valid and complete, the seller should acquire the ownership of that commodity to be sold. In other words, one cannot sell a commodity that belongs to a third party. The third condition that must be satisfied is that the commodity to be sold must be in the physical possession of the seller at the time of sale; therefore, if the seller acquired the ownership of the commodity but has not yet received it, he cannot sell it. There are only

⁴⁵ Ibid.

two exceptions to this general principle in the *Sharia'a*. One is *Salam* and the other is *Istisna'*. Both are sales of a special nature.⁴⁶

Maulana Taqi Usmani defines *Salam* as “a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advanced price fully paid at spot.”⁴⁷ The main idea behind this type of sale is to meet the needs of small farmers who need money to grow their crops and to feed their families’ up to the time of the harvest. After the prohibition of *Riba*, they could not take interest-based loans. Therefore, it was allowed for them to sell the agricultural products in advance.⁴⁸

Salam is considered a very successful instrument of Islamic finance because it is beneficial to both the buyer and the seller involved in a transaction. First, it is beneficial to the buyer because normally, the price in *Salam* is lower than the price in spot sales. Moreover, it is also beneficial to the seller, because he receives the price prior to delivering the commodity. The permissibility of *Salam* under the *Sharia'a* was an exception to the general rule that prohibits the forward sales, and therefore, it was subject to more strict conditions than other types of sale.

II. Basic Features of *Salam*

It is essential for a valid *Salam* transaction that the buyer pays the full price to the seller at the time of the sale. This is necessary because in the absence of full payment by the buyer, it will be equivalent to the sale of a debt against a debt, which is prohibited by the *Sharia'a*. Another basic condition for *Salam* is that the specifications of the commodity to be sold must be well described to both the buyer and seller. The commodities whose quality or

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ Ibid.

quantity is not determined by specification cannot be sold through the contract of *Salam*. It is necessary that the quality of the commodity to be purchased through *Salam* be fully specified leaving no ambiguity, which sometimes leads to disputes. Another point that requires attention is that a *Salam* transaction cannot take place on a particular commodity before delivery because there is a possibility that it may be destroyed, and, given such possibility, the delivery remains uncertain. Also, the exact date and place of delivery must be specified in the contract. For example, if gold is purchased in exchange for silver, it is necessary, according to *Sharia'a*, that the delivery of both be simultaneous. All the Islamic scholars have approved that *Salam* will not be valid unless these conditions are fully observed, in accordance with the most famous *hadith* by The Holy Prophet: “Whoever wishes to enter into a contract of *Salam*, he must effect the *Salam* according to the specified measure and the specified weight and the specified date of delivery.”⁴⁹

Our discussion shows that *Salam* evolved as a form of financing for small farmers and traders and as a result, the use of *Salam* transactions in modern banks and financial institutions is very popular for financing the agricultural sector. Since the price in *Salam* transactions may be set at a lower rate than the price of those commodities delivered on the spot, the difference between the two prices is a valid profit for the banks or financial institutions.

In order to ensure that the seller will deliver the commodity on the specified date, banks and financial institutions may ask him to provide a security or a guarantor. Therefore, in case of default in delivery, the guarantor may be asked to deliver the same commodity. On the other hand, if there is a security, the bank or financial institution can use it to obtain the

⁴⁹ Ibid.

required commodity by purchasing it from the market or to recover the price advanced by them. The main obstacle in *Salam* transactions faced by modern banks and financial institutions is that they receive commodities from their clients, and not money. Being familiar in dealing with money only, it is a burden for them to receive different commodities from different clients and then sell them to the public. Moreover, they cannot sell these commodities before they are actually delivered to them, because it is prohibited in *Sharia'a*.⁵⁰

An option available to banks and financial institutions to facilitate operating within the *Sharia'a* principles is to sell the commodities through a parallel contract of *Salam* for the same date of delivery. Since the period of *Salam* in the second parallel transaction is shorter than the first transaction, the price may be a little higher, and the difference between the two prices becomes the profit earned by the bank or financial institution. Moreover, if a parallel contract of *Salam* is not possible for one reason or another, they can obtain a promise to purchase from a third party. Since it is only a promise, and not the actual sale, the clients will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the bank or financial institution receives the commodity, it will be sold to the third party according to the terms of the promise. Another option sometimes proposed is that, at the date of delivery, the commodity is sold back to the seller at a higher price. But this suggestion is not inline with the Islamic principles. If the purchased commodity is sold back to the seller before the buyer takes its delivery, at a higher price, this is equivalent to *Riba*, which is prohibited. Even if it is sold back to the seller after taking delivery from him, it cannot be prearranged at the time of the original sale. Therefore this proposal is not acceptable at all.⁵¹

⁵⁰ Ibid.

⁵¹ Ibid.

A critical observation that we should not overlook is that whenever we discuss Islamic modes of financing, the fact that financial institutions deal in money only is foreign to the *Sharia 'a*. If these institutions want to earn a legitimate profit, they have to deal with commodities in one-way or the other. This is due to the fact that no profit is allowed in the *Sharia 'a* based on advancing loans only. Therefore, the establishment of an Islamic financial system requires a basic change in the approach and in the outlook of financial institutions. They shall have to establish a special sector that deals with commodities. If such a sector is established, it should not be difficult to purchase commodities through *Salam* transactions and to sell them in spot markets.

4.2.4.3 *Istisna*

I. Definition of *Istisna*

Istisna is the second exception to the basic rules of sale within *Sharia 'a* law. In this type of sale, the commodity is transacted before it comes into existence. In other words, the manufacturer is ordered to produce a specific commodity for the purchaser before he receives the payment. If the manufacturer undertakes to produce the goods for the client using his own material, an *Istisna* transaction comes into existence. It is vital that the price is fixed between the two parties and the specifications of the commodity to be manufactured are known for an *istisna* transaction to be valid. An *Istisna* transaction simply creates a moral obligation between the producer and the client. The contract may be revoked by anyone of the two parties involved after giving a notice to the other before the producer starts the manufacturing

process. However, after the manufacturer has started the work, one side cannot revoke the contract.⁵²

Unlike the contract of *Salam*, it is not required in an *Istisna* contract to specify the time of delivery although a maximum period could be fixed. In this case, if the producer delays the delivery of the commodity after the set time limit, the client will not be required to accept the commodity or pay the set amount. In order to prevent the late delivery of commodities, a penalty levied on the producer may be calculated on a daily basis. Islamic scholars have not made any statements regarding the acceptability of imposing a penalty related to the time of delivery in the *Istisna* contract.⁵³

II. Basic rules of *Istisna*

Istisna transactions are commonly used as a method of financing in the building sector. A bank or a financial institution may construct a house or build a highway for a client on the basis of *Istisna*. Since one of the main characteristics of an *Istisna* contract is that the payment may be deferred, both parties may fix the time of payment whenever they wish. They may also decide to settle the payment in installments. Moreover, the bank or financial institution may engage in a parallel contract with a third party such as a contractor for the building process. In this scenario, the cost may be calculated and the price may be set in such a manner so that the bank or financial institution can generate a reasonable profit.

The bank or financial institution is responsible for the building or construction process as specified in the agreement between the two parties. In the case of an

⁵² Ibid.

⁵³ Ibid.

inconsistency, the bank is responsible for the amendments necessary to bring the project in terms with the contract.⁵⁴

4.2.4.4 *Ijarah*

I. Definition of *Ijarah*

The term *Ijarah* in Arabic literally means to give something on rent. In this context when we use the term *Ijarah*, we will refer to the right to use and enjoy the profits and advantages of assets and properties belonging to a financial institution as long as the property is not damaged or altered in any way. This is usually done in exchange for a rent claimed by the bank or financial institution. In this case, the term '*Ijarah*' is comparable to the English term 'leasing'. Economists have established that leasing is valid within the *Sharia*'a rules and could be used as a mode of financing.⁵⁵

II. Basic rules of *Ijarah*

There are some basic differences between *Ijarah* and contemporary financial leasing that must be acknowledged in order for the contract to be valid within *Sharia*'a law. One of the major basic differences is the commencement of the *Ijarah* contract. We know by now that forward sales are prohibited under *Sharia*'a law but on the other hand, *Ijarah* for a future date is allowed given that the rent will be paid only after the asset is delivered to the client.

Another point that we must pay attention to is that in an *Ijarah* contract, the bank or financial institution is liable to pay all the expenses involved in the process of

⁵⁴ Ibid.

⁵⁵ Ibid.

purchasing the commodity and importing it to the country of the client. The bank or financial institution can include all these expenses in the cost and can take them into consideration when setting the price.

In an *Ijarah* contract, the client is usually held accountable for any loss caused to the asset by his misuse or negligence. He is also responsible for wear and tear that occurs during normal usage of the asset. On the other hand, the client cannot be responsible for a loss caused by the factors beyond his control.⁵⁶

Another point that should be taken into consideration is that since it is very risky for banks and financial institutions to set a fixed rent for the whole period due to the volatility of market conditions, the *Ijarah* contract could be set in such a way that it could increase by a certain percentage after a certain period. Another option also available for the bank or financial institution is to set a short-term *Ijarah* contract that may be renewed. Both parties are not obliged to accept the new terms and have the freedom to refuse the new contract.⁵⁷

The late payment of rent is treated in a unique way under Islamic principles. The bank or financial institution may not charge the client an additional amount in this case since it is considered *Riba*. As a result, Islamic scholars have found a solution in order to prevent consequences resulting from the misuse of this prohibition. They suggested that the client could be asked to pay a certain amount to charity. Thus, it is a responsibility for the bank or financial institution to maintain a charity account where such amounts could be deposited for charitable purposes and for providing interest-free loans to the needy.

⁵⁶ Ibid.

⁵⁷ Ibid.

The termination of an *Ijarah* contract must also be carried out in an Islamic manner. The bank or financial institution may not terminate the contract unless the client breaches any of the agreements outlined in the contract. However, if the client is not responsible for any infringement, the contract must be terminated with mutual agreement.⁵⁸

4.2.5 Issues In Islamic Banking from a Micro-perspective

Now, we shall discuss some relevant issues with reference to the underlying Islamic principles and their practical applicability in financial transactions, because without a proper understanding of these issues, some of the concepts may remain ambiguous.

1. Pricing cash and credit sales differently in Murabahah

The first and foremost point about *Murabahah* is that, it always takes place on the basis of deferred payment. The bank or financial institution purchases the commodity on cash and sells it to the client on credit. When selling the commodity on credit, it takes into account the period in which the amount is to be paid by the client and increases the price accordingly. The longer the maturity of the *Murabahah* contract, the higher the price paid. Therefore, the price in a *Murabahah* transaction is always higher than the market price. If the client is able to purchase the same commodity from the market on cash payment, he will have to pay much less than in a *Murabahah* transaction on a deferred payment basis.

⁵⁸ Ibid.

Some Islamic scholars argue that the price increase in a credit sale, which is based on the time given to the purchaser, should be treated like the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis they argue that the *Murabahah* transactions, as practiced in the Islamic banks, are not different in essence from the interest-based loans advanced by conventional banks.⁵⁹

However, other Islamic scholars disagree with that argument and raise a few points in defense of *Murabahah* as a mode of Islamic finance. First, modern capitalist theory does not differentiate between money and products. When it comes to exchange, money and products are treated based on their value. Both can be traded and both can be sold at whatever price the parties agreed on. Mutual agreement is the only requirement.

The *Sharia'a*, however, does not agree with this. According to Islamic principles, money and products have different characteristics and should be treated in a different way.⁶⁰ All the units of money of the same denomination are equal to each other. On the other hand, an old and dirty note has the same value as a new note while an old car does not have the same value as a new one. Another difference between money and products is that with products the transaction of sale and purchase is done on a particular individual product, or at least, on the products that have particular specifications. Money, on the contrary, cannot be pinpointed in a transaction of exchange.⁶¹

Since goods and services have intrinsic value, the owner is free to sell them at whatever price he wants, subject to the forces of their demand and supply. If the seller does not engage in fraud or misrepresentation, he can sell the goods and services at a price higher

⁵⁹ "Murabahah", Failaka International, Accessed on 31st May 2005
<<http://www.failaka.com/Library/Articles/Usmani%20-%20Murabaha.pdf>>

⁶⁰ Ibid.

⁶¹ Tariq Talib AL-Anjali, "Islamic Economics and Banking," Witness Pioneer Homepage, 2002
<http://www.witness-pioneer.org/vil/Articles/economics/islamic_economics_banking.htm>

than the market price with the agreement of the purchaser. If the purchaser accepts to buy them at the increased price, the additional amount charged is permissible for the seller. When he can sell his goods or services at a higher price in cash transactions, he can also charge a higher price in a credit sale, subject only to the condition that he neither deceives the purchaser, nor forces him to purchase.⁶²

It is sometimes argued that the increase of price in a cash transaction is not based on the deferred payment therefore it is permissible. However, in a sale based on deferred payment, the increase is purely against time, which makes it equivalent to interest. This argument is again based on the misconception that whenever price is increased based on the time of payment; the transaction comes within the field of interest. This is not correct. Excess amounts charged against late payments are *Riba* only where the medium of exchange is money on both sides. But if a commodity is sold in exchange for money, the seller, when fixing the price, may take into consideration different factors, including the time of payment. A seller, being the owner of a commodity that has intrinsic utility may charge a higher price, and the purchaser may agree to pay due to various reasons such as the high demand of certain commodities or the fact that the seller is more courteous in his dealings than others.

Likewise, if a seller increases the price because the purchase is on credit, Sharia'a does not prohibit this as long there is no cheating and the purchaser accepts the deal with open eyes. It is true that when increasing the price of a commodity, the seller has to keep in mind the time of its payment, but once the price is fixed, it relates only to the commodity, and not to the time. This is why if the purchaser fails to pay at a specific time, the price will remain the same and can never be increased by the seller.

⁶² "Murabahah", Failaka International, Accessed on 31st May 2005
<<http://www.failaka.com/Library/Articles/Usmani%20-%20Murabaha.pdf>>

There are two conclusions to be drawn from this. First, when money is exchanged for money, no excess is allowed, neither in cash nor credit transactions. Time of payment may act as a factor for determining the price of a commodity, but it cannot act as an exclusive basis for the sole consideration of excess claimed in exchange of money for money. Second, what has been allowed above is that the price of the commodity in a credit sale can be fixed at more than the cash price. But if the sale takes place at the cash price, and the seller has imposed a condition that in case of late payment he will charge a percentage as a penalty, this is completely prohibited. What is being charged in this case is not part of the price; it is essentially an interest charged on a debt. The practical difference between the two situations is that where the additional amount is a part of the price, it may be charged on a one-time basis only. If the purchaser fails to pay it on time, the seller cannot charge another additional amount. The price must remain the same without any addition.⁶³

2. Interest rates used as a point of reference

Many Islamic financial institutions use the current interest rate, mostly LIBOR (the London inter-bank offered rate) to determine their profit or mark-up. For example if LIBOR is 4%, they determine their mark-up on *Murabahah* will be equal to LIBOR or some percentage above LIBOR. This practice is often criticized on the ground that profit based on a rate of interest should be prohibited as interest itself.

Unquestionably, the use of interest rates for determining a profit is not desirable under Islamic principles. It indeed makes the transaction resemble an interest-based transaction, at least in appearance, and bearing in mind the severity of prohibition of interest by the *Sharia'a*, this resemblance should be avoided. Some Islamic scholars argue that if the transaction fulfils all the conditions, using an interest rate as a benchmark for determining the

⁶³ Ibid.

profit it does not render the transaction invalid or prohibited because the deal itself does not contain interest. The rate of interest has been used only as an indicator or as a benchmark.

Islamic banks and financial institutions should eliminate this practice from their operations as soon as possible, because it takes interest rates as an perfect model for business practices, which is not desirable. As well, it does not advance the basic philosophy of Islam, and has no impact on the system of Islamic financial distribution. Therefore, the Islamic banks and financial institutions should try to develop their indicators.

3. Promise To Purchase by the client

A very important issue in a *Murabahah* contract that has been the subject of debate between the *Sharia 'a* scholars is that a bank or financial institution cannot sell a commodity to a client unless it has ownership of the commodity as well as its physical possession. This situation is of very high risk to the bank since the client may refuse to purchase the commodity from the bank after the bank acquires its ownership. The commodity may be personalized to the buyer and have no general demand in the market, making it difficult to sell. The solution would be to ask the client to sign a promise to purchase the commodity when the bank acquires it. This is based on the objection that a one-sided promise creates a moral obligation but it cannot be enforced, according to *Sharia 'a*, by the courts of law.⁶⁴

In fact, the Holy Qur'an is very particular about fulfilling promises. The Holy Qur'an says: "And fulfill the covenant. Surely, the covenant will be asked about (in the hereafter)."⁶⁵ Another verse from the Qur'an relating to the same point is "O those who believe, why do

⁶⁴ Ibid.

⁶⁵ Qur'an: Surah Bani Isra'il, verse 34

you say what you not do. It invites Allah's anger that you say what you not do."⁶⁶. This verse of the Holy Qur'an specifies that if one promises to do something, no matter whether it is for a worship purpose or a contract, it is an obligation to do it.

4. Guaranteeing a Transaction

The bank or financial institution may have an alternative guarantor, who will be liable to pay the amount guaranteed by him in case of default. Two significant issues exist with respect to guaranteeing in Islamic banking. First, the guarantor does not normally guarantee a payment without charging a fee. However, the most the guarantor can do in Islamic Banking is to ask for secretarial expenses incurred, but the guarantee itself should be free of charge. The reason for this prohibition is that the person who advances money to another person as a loan cannot charge a fee for advancing a loan, because it is considered *Riba*, or interest, which is prohibited. The guarantor should be subject to this prohibition, because he does not advance money. He only undertakes to pay a certain amount on behalf of the original debtor in case he defaults in payment. Tarek El Diwany wrote, "If the person who actually pays the money cannot charge a fee, how can a person who was only undertaken to pay and did not pay anything charge a fee?"⁶⁷

The second issue is that some contemporary scholars are considering the problem from a different angle. They felt that the guarantee has become a necessity, especially in international trade where the sellers and the buyers do not know each other, and the payment of the price by the purchaser cannot be concurrent with the supply of goods. There has to be an intermediary who can guarantee the payment. It is difficult to find the guarantors who can provide this service free of charge in required numbers. Keeping this in mind, some *Sharia'a*

⁶⁶ Qur'an: Surah Al-Saf: Verse 2

⁶⁷ Tarek El Diwany, "Is Islamic banking Islamic?" Islamic Research Foundation International, <http://www.irfi.org/articles/articles_301_350/is_islamic_banking_islamic.htm>

scholars are adopting a different approach. They say the prohibition of a guarantee fee is not based on any specific injunction of the holy Qur'an, but has merely been deducted from the prohibition of *Riba* as one of its consequences. Moreover, guarantees in the past were of a simple nature. In today's commercial activities, the guarantor sometimes needs a number of studies and a lot of secretarial work. Therefore, the prohibition of the guarantee fee should be reviewed in this perspective.⁶⁸

5. The default in payment

A large problem facing Islamic banks is that if a client defaults in payment at the due date, the price cannot be increased. In interest-based loans, the amount of loan keeps on increasing according to the period of default. But, in Islamic financing, once the price is fixed, it cannot be increased. This restriction is sometimes exploited by dishonest clients who purposely avoid to pay the price at its due date, because they know that they will not have to pay any additional amount.⁶⁹

This should not create a big problem in a country where all banks and financial institutions are run on Islamic principles, because the government or the central bank may develop a system where such defaulters may be penalized by depriving them from obtaining further services from any financial institution. This system may serve as deterrent against deliberate defaults. However, in the countries where the Islamic banks work along with conventional banks and financial institutions based on interest, this system will not work,

⁶⁸ "Murabahah", Failaka International, Accessed on 31st May 2005
<<http://www.failaka.com/Library/Articles/Usmani%20-%20Murabaha.pdf>>

⁶⁹ Ibid.

because even if the client is deprived from obtaining a loan from an Islamic bank, he can still use the conventional institutions.⁷⁰

In order to solve this problem, some scholars have suggested that dishonest clients who deliberately default in their payments should be forced to pay compensation to the Islamic bank for the loss it may have suffered due to their default. They suggest that the amount of this compensation may be equal to the profit given by that bank to its depositors during the period of default. The majority of present day scholars do not accept this concept of compensation since it neither conforms to the principles of *Sharia'a* nor does it solve the problem of default. They say any additional amount charged from a debtor is *Riba*.⁷¹

Other scholars think that the defaulter should be excused from the compensation if it appears that his non-payment is due to poverty or hardship. But in practical application, every debtor may claim that his default is due to his financial inability at the due date, and it is impossible for a financial institution to inquire about each client to verify whether or not he was able to pay. What the banks normally do is that they assume every client is able to pay unless he has been declared as bankrupt.⁷²

In fact, the suggestion of the compensation equal to the rate of profit of the investment account is based on the concept of opportunity cost of money, which is foreign to the principles of *Sharia'a*. Islam does not recognize opportunity cost of money, because after the elimination of interest from the economy, money has no definite return. It is always exposed to loss as well as possessing the ability to generate profit. Once again, in practical terms, there is no difference between interest and the late payment fee charged as compensation.

⁷⁰ Ibid.

⁷¹ Ibid.

⁷² Ibid.

We have already mentioned that the real solution would be to develop a system where the defaulters are punished by depriving them from enjoying further financial services in the future. But since this is not possible in a country with a dual financial system (Islamic and conventional institutions), an alternative has been recommended. The central bank of Pakistan suggests that when entering into a transaction, the client should agree that in case he defaults in payment at the due date, he shall agree to pay a specified amount to a charitable fund maintained by the bank. It must be insured that no part of this amount shall form part of the income of the bank. The bank may establish a charitable fund for this purpose and all amounts credited shall be exclusively used for purely charitable purposes approved by the Islamic principles.⁷³

Another issue in Islamic banking that causes debate is the explicit and implicit guarantees given by Islamic banks on all deposits and investments they receive. In certain cases, there are laws and regulations that are formally written in contracts. In other cases, the public, the authorities and the bank understand the arrangement implicitly. If there is a guarantee by the bank on a deposit or investment it receives, this automatically eliminates risk from the transaction. Not only does this violate Islamic financial law, it makes PLS modes of financing similar to non-PLS modes through the reduction of their risk element. Sharing the risk is a pillar in the principles of Islamic finance and should not simply be overlooked.⁷⁴

⁷³ Pakistan Central Bank, Frequently Asked Questions, Accessed on 26th May 2005
<<http://www.sbp.org.pk/ibd/faqs.asp>>

⁷⁴ Tarek S. Zaher and M. Kabir Hassan, "Comparative Literature Survey of Islamic Finance and Banking" Financial Markets, Institutions & Instruments. Vol 10, Issue 4 (November 2001)

6. Actual application of Profit-Loss Sharing (PLS) principle

In a lot of cases, Islamic banks have advertised a predetermined rate of return on investment deposits. This is a consequence of the bargaining process that occurs between the bank and its clients before a transaction occurs and results in both sides involved agreeing on specific terms. Another motive for the use of predetermined rates of return is the pressure induced by central banks. Central banks discourage variations in the rates of returns offered by commercial banks to clients since a large variation in the returns may cause deposit shifting, which may result in the destabilizing of the economy. To avoid this destabilization, a range is specified, within which banks and customers are allowed to bargain.

This situation displays an obvious violation of Islamic financial principles. Not only does it remove the certainty of the transaction needed to legitimate the bargain, it also defies the whole purpose of using a profit-loss sharing scheme.

7. Increased use of non-PLS modes

Another point that requires attention is the rise in financing using non-PLS modes. The Dow Jones Islamic Market Index (DJIM) shows that majority of Islamic banks operate through less risky, shorter-term non-PLS modes such as leasing, mark-up and lease purchase transactions. Aggregate data from the DJIM, shows that 72.2 percent of the line of credit made available by Islamic development banks to member countries to promote Islamic banking used non-PLS modes of financing.

Table 2: Performance Measures of DJIM (1996-1998)⁷⁵

| Validity | 1996 | 1997 | 1998 | History | |
|--|------------------|--------------|-----------------|----------------|-------------------|
| DJIM | 8.30% | 13.40% | 16.00% | 12.94% | |
| DJ US | 11.47% | 17.23% | 19.70% | 16.46% | |
| DJ World | 7.08% | 12.39% | 16.48% | 12.56% | |
| S & P 500 | 11.58% | 17.82% | 19.86% | 16.76% | |
| MSCI World | 7.42% | 12.78% | 16.36% | 12.71% | |
| Returns | 1996 | 1997 | 1998 | History | |
| S & P 500 | 20.26% | 31.01% | 20.67% | 99.57% | |
| DJ US | 20.49% | 31.69% | 26.78% | 101.17% | |
| DJ World | 10.99% | 12.58% | 20.22% | 50.20% | |
| DJIM | 20.24% | 18.79% | 15.91% | 79.84% | |
| MSCI World | 14.81% | 20.76% | 19.15% | 65.21% | |
| | | | | | |
| Sharpe Ration | 1996 | 1997 | 1998 | | |
| S & P 500 | 1.31 | 1.44 | 1.12 | | |
| DJ US | 1.35 | 1.53 | 1.13 | | |
| DJ World | 0.84 | 0.59 | 0.96 | | |
| DJIM | 1.83 | 1.01 | 1.34 | | |
| MSCI World | 1.32 | 1.21 | 0.9 | | |
| | | | | | |
| Annualized Tracking Errors 12/31/95 to 12/31/98 | | | | | |
| | S & P | DJ US | DJ World | DJIM | MSCI World |
| S & P 500 | - | 0.62% | 6.52% | 4.73% | 6.41% |
| DJ US | 0.62% | - | 6.30% | 4.55% | 6.18% |
| DJ World | 6.52% | 6.30% | - | 2.76% | 2.17% |
| DJIM | 4.73% | 4.55% | 2.76% | - | 3.17% |
| MSCI World | 6.41% | 6.18% | 2.17% | 3.17% | - |
| | | | | | |
| Correlation 13/31/95-12/31/98 | | | | | |
| | S & P | DJ US | DJ World | DJIM | MSCI World |
| S & P 500 | - | 99.86% | 62.01% | 92.26% | 83.91% |
| DJ US | 99.86% | - | 82.69% | 92.52% | 84.61% |
| DJ World | 82.01% | 82.69% | - | 94.74% | 96.62% |
| DJIM | 92.26% | 92.52% | 94.74% | - | 93.35% |
| MSCI World | 83.91% | 84.61% | 96.62% | 93.35% | - |
| | | | | | |

⁷⁵ Ibid.

The above issues, as addressed and discussed, present a series of genuine challenges and threats to the effective implementation of an Islamic Banking System at the micro level. I am of the opinion that the Islamic banking system is constantly influenced by the prevalent norms practiced by the long established conventional banking system. The real challenge is to maintain a course as drawn by Islam and *Sharia'a* and avoid compromising Islamic values for the sake of gaining a foothold in the banking industry. Meanwhile, the Islamic financial system has two fundamental functions: first, develop a regulatory and supervisory framework, which is a crucial step towards the smooth integration of Islamic markets; and second, embark on plans to coexist with the conventional system, again without compromising the ethical, moral and spiritual values as preached by the Qur'an.

Currently, the Islamic financial system is experiencing a loss of identity. There appears to be a weakening of the distinctive features of Islamic banks making this alternative less unique, as it increasingly emulates the conventional banking system. For example, many of the existing regulations are based on the Western banking model; a uniform regulatory and legal framework that is supportive of an Islamic financial system has not yet been developed. Thus, we will now turn to the important issues of the legal and regulatory frameworks in Islamic finance.

5. Legal, Regulatory and Prudential Framework

An appropriate and effective framework is vital in order to manage and supervise Islamic financial institutions. Popiel identifies “three levels or components to a framework; the laws, the regulation and the prudential regulations.”⁷⁶ An unambiguous prudential regulatory system is essential to ensure that supervision is fair and thorough. Effective supervision is just as necessary and desirable in Islamic banks as it is in conventional banking. The supervision is part of a regulatory framework the goal of which is to provide market discipline, internal governance and a dynamic operating environment. Supervision verifies and ensures that all the laws and regulations are observed. This section of the essay emphasizes the features of Islamic banking that need to be identified and tackled in order to improve the supervision in the conduct of an Islamic banking framework.

As I have mentioned before, the lack of uniformity in the forms of Islamic financial practice between one country and another makes it very difficult to generalize what might be considered Islamic banking in practicality. Some Islamic modes of financing may be accepted in one country but rejected in another, and for that reason I have introduced a paradigm version of the different modes of financing earlier to provide a benchmark for our discussion. The variability of the involvement of the public sector in banking operations from one country to another is also a source of confusion and forms a key constraint. For example, countries like Iran and Pakistan experience full or major public control of the financial system while other countries such as Malaysia are more liberal in conducting their activities.

A well-developed framework is critical in an Islamic banking system at two levels: the macroeconomic and the microeconomic. At the macroeconomic level, the first reason for

⁷⁶ Paul Popiel, Financial risk and the legal, regulatory and prudential framework.

legislating, regulating and supervising the financial institution is the prevention of systematic failures. Financial institutions have the responsibility for mobilizing, as well as allocating, resources, creating money, maintaining deposits and operating the payment system. They are the principal conduits for central bank's monetary policy. Fragile banks may undermine the public confidence in the financial sector, thus creating problems that may become systematic. At the microeconomic level, the main reason to legislate, regulate and supervise an Islamic financial system is the protection of its depositors and investors. In this case, this is crucial due to the asymmetry of information that exists between a bank and its clients.⁷⁷

In any financial system, information is not equally distributed among all the agents involved; as a result, different agents have different information sets. In addition, not all parties have the same ability to utilize the information available to them. In particular, parties have more information about themselves than do others. The problem arises because information is not a free good and obtaining this information can sometimes be costly.

In Islamic financial institutions, investors and depositors are not guaranteed a fixed return. Their profit or loss is subject to the profit or loss of the investment projects in which their money is utilized. The asymmetry of information in this case is far more severe than in a conventional banking system. It leads to lack of protection to depositors, which is a major difference between conventional and Islamic banking systems.

Since intentions cannot be observed in a financial system, there may be incentives to lie or mislead a counterpart. A particular problem that originates from asymmetric information is called the moral hazard, which arises when a contract or financial arrangement creates incentives for parties to behave against the interest of others.

⁷⁷ Ibid.

Another problem that arises from the central problem of asymmetry of information is the agency problem. Popiel wrote, “Agency problem arises when a manager or an employee of a company creates through her or his behavior a personal conflict of interest vis-à-vis the other stakeholders in the company.”⁷⁸

We know from our introduction of the paradigm version of Islamic banking that its core activities rely on profit-loss sharing schemes; therefore, investment risk is the most critical operational risk involved in the operations of Islamic banks. The assessment of that risk is much more difficult in an Islamic banking framework than it is in a conventional system. This is the case because of several factors. First, the calculation of the profit-loss sharing ratio on investment projects is very complex and must be determined fairly, which is often difficult to ascertain. Secondly, since the bank invests its funds in projects that have a separate management system, it does not have any power over the project’s progress or profitability. Another difficulty that arises with risk assessment is the non-existence of collateral or other guarantees through which the profit-sharing schemes can be dependent.⁷⁹

Therefore, in order to protect investment projects and increase their profitability, Islamic banks should focus on and enhance risk management. Moreover, an extremely skilled labor force that is professionally trained in that sector should be employed to implement these policies. Obtaining the required human capital is a very long procedure but it is critical for the success of such a system; this is an ongoing process that Islamic banks must go through in order to achieve their targets.

⁷⁸ Paul A. Popiel, Management of Financial Systems and of Financial Crises, pg 95, Vol. 1, Background Paper for the Ec 4508 Course at the Economics Department Carleton University

⁷⁹ M. Umer Chapra and Tariqullah Khan, “Regulation and supervision of Islamic banks,” Occasional Paper No.3, Islamic Development Bank & Islamic Training and Development Institute

A strong and healthy financial system is an evolving component of the economy. Therefore, it is essential to keep updating the legal and regulatory framework along with economic growth and diversification. The legal dimension of the framework is very difficult to amend by nature; therefore, regulation is a flexible instrument to adjust the law. However, without evolutionary change, the evolving structure of the financial system and of its constituent institutions diminishes the frameworks' effectiveness.⁸⁰

5.1 Legal aspect of Supervision

To be able to establish the legal foundations for the supervision of Islamic banks, it is crucial that the general banking laws or specific laws related to Islamic finance describe in detail the nature of these banks and their relationship with the central bank and other conventional banks. This legal foundation should include unambiguous information regarding the licensing of the banks, the modes of financing allowed, and affirm the powers to enforce compliance with laws and regulation.⁸¹ Such conditions should categorize the bank as an 'Islamic Bank' and allow it to carry on its operations under the umbrella of Islamic principles.

5.2 Management of Operational risk

Any central bank that allows Islamic banking operations has a responsibility to ensure that they are adequately regulated and supervised. Supervision requires the collection and analysis of information, which can be done both on-site and off-site. An effective supervisory

⁸⁰ Popiel, Paul, Financial risk and the legal, regulatory and prudential framework, Background Paper for FSYM Seminar 1608 at the Economics Department Carleton University

⁸¹ Luca Errico and Mitra Farahbaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision," IMF Working Paper, International Monetary Fund, (March 1998)

system will use both means. Examiners and external auditors that regularly assess the bank's situation to observe a variety of factors carry out what we call on-site supervision. The variables examined include the accuracy of reports, the overall operations and condition of the bank, the adequacy of the bank's risk management system and internal control procedures, the competence of management, the adequacy of accounting and management information systems and the banks adherence to laws and regulations and the terms stipulated in the banking license.⁸² On the other hand, off-site supervision includes sending balance sheets and other financial information to the central bank, where it is examined by financial experts to test for accuracy between the actual and reported figures.

The main objective of such regulations would be to use information to help identify any signs of deterioration in banks' performance. The monitoring would be mainly based on the CAMEL-rating framework. The CAMEL rating is a measure of the reliability of a bank and is calculated on a 1-5 scale, with one being a very strong performance, and five being very weak.⁸³ CAMEL stands for capital adequacy, assets quality, management of accounts, earnings quality, and liquidity. These are the five most important aspects of a bank's operation, reflecting the bank's financial condition, overall operating soundness and compliance with supervisory regulations.

In a CAMEL rating system, capital adequacy is assessed according to four factors. The first is the volume of risk assets; the second is the volume of the marginal and inferior assets; the third, bank growth experience, plans and prospects for the future; and the fourth is the management strength. PLS transactions are based on risk sharing and are the heart of

⁸² "Core principles for effective banking supervision", Basle Committee 1997, P33.
<<http://www.bis.org/publ/bcbs30a.pdf>>

⁸³ Luca Errico and Mitra Farahbaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision," IMF Working Paper, International Monetary Fund, (March 1998)

Islamic finance, thus, they should make up the majority of the bank's operational assets. Assets obtained from PLS transactions are far riskier than the assets obtained from non-PLS transactions, since the only risk involved in non-PLS transactions is creditworthiness, and hence, the ratio of the risky assets to total assets in an Islamic banking framework should be much higher than under conventional frameworks. The Basle Committee set the international standard for the capital adequacy ratio to be at least 8 percent of risk-weighted assets. In reality however, PLS transactions are a very small fraction of the total assets and therefore, it is logical to conclude that the evaluation of capital adequacy for Islamic banks should be based on the assessment of the mix of PLS and non-PLS assets.⁸⁴

There are also four factors that are used to evaluate asset quality in a CAMEL framework. The first factor is the level and distribution of assets; the second factor is the level and composition of impaired assets; the third factor is the adequacy of valuation reserves, and the last factor is the demonstrated ability to administer and collect problem credits.⁸⁵ Like conventional banks, Islamic banks are expected to maintain assets that are of a sound quality. They are also expected to have policies and procedures in place to ensure that any impairment of assets is timely identified and provisions are maintained to reflect such impairment.

Management of accounts is evaluated according to six different factors in the standard CAMEL framework. The first factor is technical competence, leadership and administrative ability; the second factor is compliance with banking regulations; the third factor is the bank's ability to plan and respond to changing circumstances; the fourth factor is the

⁸⁴ V.Sundararajan and Luca Errico , "Islamic Financial Institutions and products in the Global Financial System: Key Issues in Risk Management and Challenges ahead," IMF Working Paper, International Monetary Fund, (November 2002)

⁸⁵ Ibid.

adequacy of internal policies; the fifth is the bank's tendency toward self-dealing; and the sixth is the bank's demonstrated willingness to serve the needs of the community. Setting up a sound internal system that manages risks and authorizes transactions is vital for the effective management of operational risks.⁸⁶

Maintaining a consistent level of quality earnings is essential for the long-term health of a financial institution. Risks of economic loss as a result of poor investment decisions are readily apparent in the earnings trend of a bank. Not only would economic hazards be expressed in the depreciation of the value of the investment account holder's funds, but also in the bank's profitability and capital. If not corrected, such hazards could erode the bank's capital and render it insolvent. In a standard CAMEL framework, earnings are evaluated according to four different factors. First, the ability to cover losses and provide adequate capital; second, the banks earning trends; third, peer group comparisons; and fourth, the quality and composition of the banks' income. The earning of the bank are considered of high quality if they have the ability to absorb losses when due consideration is given to asset quality and bank growth.

The last aspect of the CAMEL framework is the liquidity of the bank. Monitoring liquidity is a very crucial responsibility of any bank management. It is evaluated according to 4 factors: the fluctuation in the level of deposits; the reliance on interest sensitive funds; technical competence relative to structure of liabilities; the available assets which could be converted into cash; and finally, the bank's access to inter-bank markets or other sources of cash.⁸⁷ The CAMEL analysis is based on a combination of on-site and off-site supervision. Experience has shown that it is well suited to Islamic banks.

⁸⁶ Ibid.

⁸⁷ Ibid.

5.3 Sharia'a Supervisory Board

Islamic Banks must conform to *Sharia'a* law, as we mentioned from the beginning of this paper, and hence, it is subject to an additional layer of authority since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of the Muslim community. For this reason, Islamic banks employ either an individual *Sharia'a* Advisor or a *Sharia'a* Board.

The *Sharia'a* supervisory board is an essential governance level for two reasons. First, those who deal with an Islamic bank want assurance that its activities are within the bounds of Islamic law. Should the *Sharia'a* supervisory board report that the management of the bank has violated the *Sharia'a*, it will quickly lose the confidence of the majority of its investors and clients. Second, some Muslim scholars argue that strict obedience to Islamic religious principles will act as a counter to the incentive problems mentioned earlier. The argument is that the Islamic moral code will prevent Muslims from behaving in ways that are ethically wrong, thus reducing the transaction costs arising from incentive issues. In effect, Islamic religious ideology acts as its own incentive mechanism to reduce the inefficiency that arises from asymmetric information and moral hazards.

5.4 The Monitoring of Islamic Banks and Information Disclosure

As we mentioned earlier, Islamic banks require an efficient monitoring system in order to conduct their policies since an absence of protection for investment depositors lies at the centre of the Islamic banking principles. As a result, public disclosure of information about banks' policy objectives and operational strategies is crucial in order to allow creditors and depositors to monitor the banks' performance. Depositors in Islamic banks require flexibility in the selection of a bank in which they can allocate their funds according to their risk preference; therefore, a clear and concise presentation of key data as well as a reduction in information asymmetries is essential. This appropriate information disclosure can supply the supervisory authorities with a better understanding of the risks involved, thus placing them in a better position to implement effective prudential supervision, thus, reducing systematic risk.⁸⁸

In the case of profit-loss sharing contracts, since profit is distributed among the firm and the bank at agreed upon ratios, there may be particular opportunities for moral hazard like an incentive on the part of an amoral agent to report lower profits, therefore keeping a larger portion for themselves. The result is a lack of popularity for profit-loss sharing contracts in Islamic banks. However, these problems are not unique to Islamic banking frameworks; they often arise in equity-based contracts in conventional systems as well.⁸⁹

Moreover, the disclosure of information would increase the flexibility of the system, and provide the supervisory authorities and the public with better information of a bank's

⁸⁸ Luca Errico and Mitra Farahbaksh, "Islamic Banking: Issues in Prudential Regulations and Supervision," IMF Working Paper, International Monetary Fund, (March 1998)

⁸⁹ Kazem Sadr and Zamir Iqbal, "Choice between debt and equity contracts and asymmetric information: some empirical evidence," Islamic banking and finance: new perspectives on profit-sharing and risk, Cheltenham: Edward Elgar. 2002

strategies and risks. Additionally, information requirements should be designed to assist supervisory authorities in addressing Islamic bank's special risks. The two areas that need particular attention are the risk management policies and the adequacy of expertise to implement these policies. Hence, the supervisory authorities should have in mind a list of factors and data elements that have to be supplied by Islamic banks. Such information should be given to supervisory authorities first, then to the public. The information supplied to the public need not be as detailed as the information supplied to supervisory authorities, but the decision should be left to the discretion of the authorities.

Supervisory authorities should have all information pertaining to risk management and internal monitoring and auditing in Islamic banks in particular, the following elements. First, it should include investment objectives and policies, including concentration. This should enable the assessment of the policies with respect to portfolio diversification. It should also contain information regarding investment objectives and the industries in which assets are concentrated. The second element to be included in the information disclosed by banks is the types of securities. This should indicate to the authorities the degree of exposure to any type of securities or other asset, particularly illiquid assets. In the case of an increased exposure of the bank to illiquid assets, the supervisory authorities should set a limit to that exposure. The third element of the information to be disclosed is the risk factors associated with the investment portfolio. Since there is an endless list of the type of activities an Islamic bank can be involved in, supervisory authorities should examine the adequacy of such activities. Islamic banks should also provide information regarding internal control.

Several responsibilities of Islamic banks are different from conventional banks such as the determination of profit-loss ratio and the auditing of the projects to ensure fairness and

justice in distribution. This makes the internal activities that happen within the bank more complex, thus requiring a higher level of monitoring. Adequate internal controls are also vital to the depositor's interest because, as we mentioned earlier, the net-profits of Islamic banks are shared with depositors. Performance data should also be disclosed to supervisory authorities since it is a key element for depositors in making a choice between financial institutions. Unsafe institutions might attract depositors by promising unrealistic rates of return, thus crowding out serious and well-managed institutions. Therefore, it becomes the responsibility of supervisory authorities to reduce the chance of these types of moral hazards. Information about the level of education and professional background of the management and senior staff should also be disclosed to supervisory authorities to guarantee that experienced bankers are making credit and investment decisions.

6. Concluding Remarks

Islamic banking is no longer a fascinating experiment, but has been transformed into a growing reality. During the last two decades, a large-scale growth in Islamic finance has nourished in Muslim countries around the world. This was a result of many factors such as the desire for socio-political and economic systems founded on Islamic principles and a stronger Islamic Identity. For Muslims, the existence of Islamic finance has fulfilled their demand for a religiously acceptable way to invest their money. They found a financial institution, which places equal emphasis on the ethical, moral, social and religious dimensions. The global integration of financial markets, structural reforms in financial systems and large-scale privatization set the road for an Islamic finance expansion.

This paper has focused on the most prominent features of an Islamic financial system, in particular, the absence of fixed interest rates. The key requirement of an Islamic financial system is the substitution of the rate of interest with the rate of return on real activities as a mechanism of allocating financial resources. While prohibiting interest, Islam encourages profit-loss sharing, which is believed to advocate risk sharing, individual's rights and duties, property rights as well as the inviolability of contracts among stakeholders.

We discussed Islamic banking from two different perspectives in this paper. First, we tackled the macro-economic perspective and discussed issues such as money creation and seignorage then we focused our attention on the micro-economic perspective and discussed the large range of modes of transactions that have been developed to allow the financial system to function without resort to contracts based on fixed interest.

However, a complete Islamic financial system is still at an early stage of advancement since the efficient working of such a system requires properly organized primary and secondary financial markets. This underdevelopment is a key problem in the trading of Islamic financial instruments and creates obstacles in the face of the co-operation among Islamic financial institutions. The result was a creation of a grey area stating what the *Sharia'a* prohibits and the terminology it uses.⁹⁰ Islamic banks have developed their own religious boards such as the *Sharia'a Supervisory Board* (SSB) for guidance. The different interpretations by different religious boards and schools of thought create confusion. A mode of financing may be accepted by one financial institution and rejected by another. Thus, the same instrument may not be valid in all countries. This lack of uniformity among Islamic

⁹⁰ Tarek S. Zaher and M. Kabir Hassan, "Comparative Literature Survey of Islamic Finance and Banking" Financial Markets, Institutions & Instruments. Vol 10, Issue 4 (November 2001)

financial institutions necessitates the creation of a universally accepted central Islamic religious authority.

The responsibility of this authority would be to define consistent rules in such a manner that confusion within Islamic banks, financial institutions and clients could be eliminated. The authority would also be required to define and introduce new products and Islamic facilities in order to modernize and match the present and future economical and banking needs of Muslims worldwide.

We also discussed that an appropriate legal, regulatory and prudential framework is essential. To help develop such a framework, a CAMEL rating system adapted to an Islamic environment has been discussed. Islamic banking is operating slightly different from its paradigm version; as a result, its all aspects of its supervision and regulation should be conducted accordingly.

On their part, the authorities should open their minds and realize the potential gains that this already sizeable and growing market could bring to the global economy in general. This type of financing has been developed to satisfy the requirements of Muslim communities all over the world, but its use has not been limited to Muslim people only. Many people of different ethnical backgrounds do not understand the basis for this type of financing and believe that it is limited to one religion. For this reason, Islamic banks and financial institutions should widen their market base by increasing advertising and marketing for this type of financing all over the globe.

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