Economics and Islam

يَٰٓأَيُّهَا ٱلَّذِينَ ءَامَنُواْ لَا تَأْكُلُوٓاْ أَمْوَٰلَكُم بَيْنَكُم بِٱلْبَٰطِلِ إِلَّآ أَن
تَكُونَ تِجَٰرَةً عَن تَرَاضٍ مِّنكُمْ ۚ وَلَا تَقْتُلُوٓاْ أَنفُسَكُمْ ۚ إِنَّ ٱللَّهَ كَانَ بِكُمْ رَحِيمًا

"O you who believe! do not devour your property among yourselves falsely, except that it be trading by your mutual consent, and do not kill yourselves. Surely Allah is Merciful to you." Qur'an [4:29]

Islam is a **complete way of life**. Allah, the Creator of humanity, has given us guidelines affecting many different aspects of our lives, including the *economic* aspect. There is a great deal of information in the Qur'an and Sunnah which describes how Muslims are to engage in economic transactions. Just as Muslims are obligated to obey the rules of Islam regarding prayer, fasting, etc., they are also commanded to obey the injunctions regarding interest for example.

Reflecting the growing and global Muslim revival, Islamic banking is widely regarded as the fastest growing segment of the international banking system. The remarkable growth and development of Islamic banks all over the world has produced greater accessibility to different services and transactions which satisfy the conditions elucidated in the Qur'an and Sunnah. Judging from the success of some of these banks (e.g. MCCA in Australia), it may be that they are pioneers into a potentially *huge and untapped* market. To top it off, they are helping bring to reality the goal of economic independence and strength to the Muslim Ummah.

Many of the following articles have been taken from ***Nida'ul Islam***, a bi-monthly magazine, produced by the Islamic Youth Movement - Media Office, Sydney-Australia.

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Principles Of Islamic Banking

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For millions of Muslims, banks are institutions to be avoided. Islam is a religion which keeps Believers from the teller's window. Their Islamic beliefs prevent them from dealings that involve usury or interest (Riba). Yet Muslims need banking services as much as anyone and for many purposes: to finance new business ventures, to buy a house, to buy a car, to facilitate capital investment, to undertake trading activities, and to offer a safe place for savings. For Muslims are not averse to legitimate profit as Islam encourages people to use money in Islamically legitimate ventures, not just to keep their funds idle.

However, in this fast moving world, more than 1400 years after the Prophet (s.a.w.), can Muslims find room for the principles of their religion? The answer comes with the fact that a global network of Islamic banks, investment houses and other financial institutions has started to take shape based on the principles of Islamic finance laid down in the Qur'an and the Prophet's traditions 14 centuries ago. Islamic banking, based on the Qur'anic prohibition of charging interest, has moved from a theoretical concept to embrace more than 100 banks operating in 40 countries with multi-billion dollar deposits world-wide. Islamic banking is widely regarded as the fastest growing sector in the Middle Eastern financial services market. Exploding onto the financial scene barely thirty years ago, an estimated $US 70 billion worth of funds are now managed according to Shari'ah. Deposit assets held by Islamic banks were approximately $US5 billion in 1985 but grew over $60 billion in 1994.

The best known feature of Islamic banking is the prohibition on interest. The Qur'an forbids the charging of Riba on money lent. It is important to understand certain principles of Islam that underpin Islamic finance. The Shari'ah consists of the Qur'anic commands as laid down in the Holy Qur'an and the words and deeds of the Prophet Muhammad (s.a.w.). The Shari'ah disallows Riba and there is now a general consensus among Muslim economists that Riba is not restricted to usury but encompasses interest as well. The Qur'an is clear about the prohibition of Riba, which is sometimes defined as excessive interest. "O You who believe! Fear Allah and give up that remains of your demand for usury, if you are indeed believers." Muslim scholars have accepted the word Riba to mean any fixed or guaranteed interest payment on cash advances or on deposits. Several Qur'anic passages expressly admonish the faithful to shun interest.

The rules regarding Islamic finance are quite simple and can be summed up as follows:

a) Any predetermined payment over and above the actual amount of principal is prohibited. Islam allows only one kind of loan and that is qard-el-hassan (literally good loan) whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one commentator "this prohibition applies to any advantage or benefits that the lender might secure out of the qard (loan) such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall." The principle derived from the quotation emphasises that associated or indirect benefits are prohibited.

b) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. As defined in the Shari'ah, or Islamic law, Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower: he must pay back his loan, with the agreed interest, regardless of the success or failure of his venture.

The principle which thereby emerges is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent). Accordingly, under Islam, either people invest with risk or suffer loss through devaluation by inflation by keeping their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors. The objective is that high risk investments provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts.

c) Making money from money is not Islamically acceptable.

Money is only a medium of exchange, a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle so that, for instance, hoarding money is regarded as being unacceptable. In Islam, money represents purchasing power which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

d) Gharar (Uncertainty, Risk or Speculation) is also prohibited.

Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials.

A number of Islamic scholars disapprove the indexation of indebtedness to inflation and explain this prohibition within the framework of qard-el-hassan. According to those scholars, the creditor advances the loan to win the blessings of Allah and expects to obtain the reward from Allah alone. A number of transactions are treated as exceptions to the principle of gharar : sales with advanced payment (bai' bithaman ajil); contract to manufacture (Istisna); and hire contract (Ijara). However, there are legal requirements for the conclusion of these contracts to be organised in a way which minimises risk.

e) Investments should only support practices or products that are not forbidden -or even discouraged- by Islam. Trade in alcohol, for example would not be financed by an Islamic bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest.

Islamic Banking

by Mohamed Ariff, University of Malaya,
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Islamic banking is a new phenomenon that has taken many observers by surprise. The whole banking system has been islamized in both Iran and Pakistan. In addition, there are some thirty Islamic banks in operation in other parts of the globe, including the Jeddah-based Islamic Development Bank (IDB) but excluding numerous non-bank Islamic financial institutions (see Appendix). What is more, the speed with which Islamic banks have sprung up and the rate at which they have progressed make it worth-while to study them systematically. An attempt is made in this paper (a) to survey the growing literature on Islamic banking, in particular (b) to trace the growth and development of Islamic banking, and (c) to highlight its salient characteristics.

Contents

Evolution

The first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in l963. This experiment lasted until l967 (Ready l98l), by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi l988). Thus, they functioned essentially as saving- investment institutions rather than as commercial banks. The Nasir Social Bank, established in Egypt in l97l, was declared an interest-free commercial bank, although its charter made no reference to Islam or Shariah (Islamic law).

The IDB was established in l974 by the Organization of Islamic Countries (OIC), but it was primarily an inter-governmental bank aimed at providing funds for development projects in member countries. The IDB provides fee- based financial services and profit-sharing financial assistance to member countries. The IDB operations are free of interest and are explicitly based on

Shariah Principles

In the seventies, changes took place in the political climate of many Muslim countries so that there was no longer any strong need to establish Islamic financial institutions under cover. A number of Islamic banks, both in letter and spirit, came into existence in the Middle East, e.g., the Dubai Islamic Bank (l975), the Faisal Islamic Bank of Sudan (l977), the Faisal Islamic Bank of Egypt (l977), and the Bahrain Islamic Bank (l979), to mention a few. The Asia-Pacific region was not oblivious to the winds of change. The Philippine Amanah Bank (PAB) was established in l973 by Presidential Decree as a specialized banking institution without reference to its Islamic character in the bank's charter. The establishment of the PAB was a response by the Philippines Government to the Muslim rebellion in the south, designed to serve the special banking needs of the Muslim community. However, the primary task of the PAB was to assist rehabilitation and reconstruction in Mindanao, Sulu and Palawan in the south (Mastura l988). The PAB has eight branches located in the major cities of the southern Muslim provinces, including one in Makati (Metro Manila), in addition to the head office located at Zamboanga City in Mindanao. The PAB, however, is not strictly an Islamic bank, since interest-based operations continue to coexist with the Islamic modes of financing. It is indeed fascinating to observe that the PAB operates two 'windows' for deposit transactions, i.e., conventional and Islamic. Nevertheless, efforts are underway to convert the PAB into a full-fledged Islamic bank (Mastura l988).

Islamic banking made its debut in Malaysia in l983, but not without antecedents. The first Islamic financial institution in Malaysia was the Muslim Pilgrims Savings Corporation set up in l963 to help people save for performing hajj (pilgrimage to Mecca and Medina). In l969, this body evolved into the Pilgrims Management and Fund Board or the Tabung Haji as it is now popularly known. The Tabung Haji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Shariah, but its role is rather limited, as it is a non-bank financial institution. The success of the Tabung Haji, however, provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB) which represents a full- fledged Islamic commercial bank in Malaysia. The Tabung Haji also contributed l2.5 per cent of BIMB's initial capital of M$80 million. BIMB has a complement of fourteen branches in several parts of the country. Plans are afoot to open six new branches a year so that by l990 the branch network of BIMB will total thirty-three (Man l988).

Reference should also be made to some Islamic financial institutions established in countries where Muslims are a minority. There was a proliferation of interest-free savings and loan societies in India during the seventies (Siddiqi l988). The Islamic Banking System (now called Islamic Finance House), established in Luxembourg in l978, represents the first attempt at Islamic banking in the Western world. There is also an Islamic Bank International of Denmark, in Copenhagen, and the Islamic Investment Company has been set up in Melbourne, Australia.

Rationale

The essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra l982), it nevertheless derives its specific rationale from the fact that there is no place for the institution of interest in the Islamic order.

Islam prohibits Muslims from taking or giving interest (riba) regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged. To be sure, there have been attempts to distinguish between usury and interest and between loans for consumption and for production. It has also been argued that riba refers to usury practiced by petty money-lenders and not to interest charged by modern banks and that no riba is involved when interest is imposed on productive loans, but these arguments have not won acceptance. Apart from a few dissenting opinions, he general consensus among Muslim scholars clearly is that there is no difference between riba and interest. In what follows, these two terms are used interchangeably.

The prohibition of riba is mentioned in four different revelations in the Qur'an.1 The first revelation emphasizes that interest deprives wealth of God's blessings. The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third revelation enjoins Muslims to stay clear of interest for the sake of their own welfare. The fourth revelation establishes a clear distinction between interest and trade, urging Muslims to take only the principal sum and to forgo even this sum if the borrower is unable to repay. It is further declared in the Qur'an that those who disregard the prohibition of interest are at war with God and His Prophet. The prohibition of interest is also cited in no uncertain terms in the Hadith (sayings of the Prophet). The Prophet condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt.2

It may be mentioned in passing that similar prohibitions are to be found in the pre-Qur'anic scriptures, although the 'People of the Book', as the Qur'an refers to them, had chosen to rationalize them. It is amazing that Islam has successfully warded off various subsequent rationalization attempts aimed at legitimizing the institution of interest.

Some scholars have put forward economic reasons to explain why interest is banned in Islam. It has been argued, for instance, that interest, being a pre- determined cost of production, tends to prevent full employment (Khan l968; Ahmad n.d.; Mannan l970). In the same vein, it has been contended that international monetary crises are largely due to the institution of interest (Khan, n.d), and that trade cycles are in no small measure attributable to the phenomenon of interest (Ahmad l952; Su'ud n.d.). None of these studies, however, has really succeeded in establishing a causal link between interest, on the one hand, and employment and trade cycles, on the other. Others, anxious to vindicate the Islamic position on interest, have argued that interest is not very effective as a monetary policy instrument even in capitalist economies and have questioned the efficacy of the rate of interest as a determinant of saving and investment (Ariff l982). A common thread running through all these discussions is the exploitative character of the institution of interest, although some have pointed out that profit (which is lawful in Islam) can also be exploitative. One response to this is that one must distinguish between profit and profiteering, and Islam has prohibited the latter as well.

Some writings have alluded to the 'unearned income' aspect of interest payments as a possible explanation for the Islamic doctrine. The objection that rent on property is considered halal (lawful) is then answered by rejecting the analogy between rent on property and interest on loans, since the benefit to the tenant is certain, while the productivity of the borrowed capital is uncertain. Besides, property rented out is subject to physical wear and tear, while money lent out is not. The question of erosion in the value of money and hence the need for indexation is an interesting one. But the Islamic jurists have ruled out compensation for erosion in the value of money, or, according to Hadith, a fungible good must be returned by its like (mithl): 'gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, and hand to hand ...'.3

The bottom line is that Muslims need no 'proofs' before they reject the institution of interest: no human explanation for a divine injunction is necessary for them to accept a dictum, as they recognize the limits to human reasoning. No human mind can fathom a divine order; therefore it is a matter of faith (iman).

The Islamic ban on interest does not mean that capital is costless in an Islamic system. Islam recognizes capital as a factor of production but it does not allow the factor to make a prior or pre-determined claim on the productive surplus in the form of interest. This obviously poses the question as to what will then replace the interest rate mechanism in an Islamic framework. There have been suggestions that profit-sharing can be a viable alternative (Kahf l982a and l982b). In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit- sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself that is predetermined.

It has been argued that profit-sharing can help allocate resources efficiently, as the profit-sharing ratio can be influenced by market forces so that capital will flow into those sectors which offer the highest profit- sharing ratio to the investor, other things being equal. One dissenting view is that the substitution of profit-sharing for interest as a resource allocating mechanism is crude and imperfect and that the institution of interest should therefore be retained as a necessary evil (Naqvi l982). However, mainstream Islamic thinking on this subject clearly points to the need to replace interest with something else, although there is no clear consensus on what form the alternative to the interest rate mechanism should take. The issue is not resolved and the search for an alternative continues, but it has not detracted from efforts to experiment with Islamic banking without interest.

Anatomy

As mentioned earlier, Islam does not deny that capital, as a factor of production, deserves to be rewarded. Islam allows the owners of capital a share in a surplus which is uncertain. To put it differently, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved. The owner of capital (rabbul-mal) may 'invest' by allowing an entrepreneur with ideas and expertise to use the capital for productive purposes and he may share the profits, if any, with the entrepreneur- borrower (mudarib); losses, if any, however, will be borne wholly by the rabbul-mal. This mode of financing, termed mudaraba in the Islamic literature, was in practice even in the pre-Qur'anic days and, according to jurists, it was approved by the Prophet.

Another legitimate mode of financing recognized in Islam is one based on equity participation (musharaka) in which the partners use their capital jointly to generate a surplus. Profits or losses will be shared between the partners according to some agreed formula depending on the equity ratio. Mudaraba and musharaka constitute, at least in principle if not in practice, the twin pillars of Islamic banking. The musharaka principle is invoked in the equity structure of Islamic banks and is similar to the modern concepts of partnership and joint stock ownership. In so far as the depositors are concerned, an Islamic bank acts as a mudarib which manages the funds of the depositors to generate profits subject to the rules of mudaraba as outlined above. The bank may in turn use the depositors' funds on a mudaraba basis in addition to other lawful modes of financing. In other words, the bank operates a two-tier mudaraba system in which it acts both as the mudarib on the saving side of the equation and as the rabbul-mal on the investment portfolio side. The bank may also enter into musharaka contracts with the users of the funds, sharing profits and losses, as mentioned above. At the deposit end of the scale, Islamic banks normally operate three broad categories of account, mainly current, savings, and investment accounts. The current account, as in the case of conventional banks, gives no return to the depositors. It is essentially a safe-keeping (al-wadiah) 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. As in the case of conventional banks, cheque books are issued to the current account deposit holders and the Islamic banks provide the broad range of payment facilities - clearing mechanisms, bank drafts, bills of exchange, travellers cheques, etc. (but not yet, it seems, credit cards or bank cards). More often than not, no service charges are made by the banks in this regard.

The savings account is also operated on an al-wadiah basis, but the bank may at its absolute discretion pay the depositors a positive return periodically, depending on its own profitability. Such payment is considered lawful in Islam since it is not a condition for lending by the depositors to the bank, nor is it pre-determined. The savings account holders are issued with savings books and are allowed to withdraw their money as and when they please. The investment account is based on the mudaraba principle, and the deposits are term deposits which cannot be withdrawn before maturity. The profit-sharing ratio varies from bank to bank and from time to time depending on supply and demand conditions.4 In theory, the rate of return could be positive or negative, but in practice the returns have always been positive and quite comparable to rates conventional banks offer on their term deposits.5

At the investment portfolio end of the scale, Islamic banks employ a variety of instruments. The mudaraba and musharaka modes, referred to earlier, are supposedly the main conduits for the outflow of funds from the banks. In practice, however, Islamic banks have shown a strong preference for other modes which are less risky. The most commonly used mode of financing seems to be the 'mark-up' device which is termed murabaha. In a murabaha transaction, the bank finances the purchase of a good or asset by buying it on behalf of its client and adding a mark-up before re-selling it to the client on a 'cost-plus' basis. It may appear at first glance that the mark-up is just another term for interest as charged by conventional banks, interest thus being admitted through the back door. What makes the murabaha transaction Islamically legitimate is that the bank first acquires the asset and in the process it assumes certain risks between purchase and resale. The bank takes responsibility for the good before it is safely delivered to the client. The services rendered by the Islamic bank are therefore regarded as quite different from those of a conventional bank which simply lends money to the client to buy the good.

Islamic banks have also been resorting to purchase and resale of properties on a deferred payment basis, which is termed bai' muajjal. It is considered lawful in fiqh (jurisprudence) to charge a higher price for a good if payments are to be made at a later date. According to fiqh, this does not amount to charging interest, since it is not a lending transaction but a trading one.

Leasing or ijara is also frequently practised by Islamic banks. Under this mode, the banks would buy the equipment or machinery and lease it out to their clients who may opt to buy the items eventually, in which case the monthly payments will consist of two components, i.e., rental for the use of the equipment and instalment towards the purchase price.

Reference must also be made to pre-paid purchase of goods, which is termed bai'salam, as a means used by Islamic banks to finance production. Here the price is paid at the time of the contract but the delivery would take place at a future date. This mode enables an entrepreneur to sell his output to the bank at a price determined in advance. Islamic banks, in keeping with modern times, have extended this facility to manufactures as well.

It is clear from the above sketch that Islamic banking goes beyond the pure financing activities of conventional banks. Islamic banks engage in equity financing and trade financing. By its very nature, Islamic banking is a risky business compared with conventional banking, for risk-sharing forms the very basis of all Islamic financial transactions. To minimize risks, however, Islamic banks have taken pains to distribute the eggs over many baskets and have established reserve funds out of past profits which they can fall back on in the event of any major loss.

Literature: Theory

It is not possible to cover in this survey all the publications which have appeared on Islamic banking. There are numerous publications in Arabic and Urdu which have made significant contributions to the theoretical discussion. A brief description of these in English can be found in the Appendix to Siddiqi's book on Banking without Interest (Siddiqi l983a). The early contributions on the subject of Islamic banking were somewhat casual in the sense that only passing references were made to it in the discussion of wider issues relating to the Islamic economic system as a whole. In other words, the early writers had been simply thinking aloud rather than presenting well-thought-out ideas. Thus, for example, the book by Qureshi on Islam and the Theory of Interest (Qureshi l946) looked upon banking as a social service that should be sponsored by the government like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit-sharing.

Ahmad, in Chapter VII of his book Economics of Islam (Ahmad l952), envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any. It was suggested that banks should cash bills of trade without charging interest, using the current account funds.

The principle of mudaraba based on Shariah was invoked systematically by Uzair (l955). His principal contribution lay in suggesting mudaraba as the main premise for 'interestless banking'. However, his argument that the bank should not make any capital investment with its own deposits rendered his analysis somewhat impractical.

Al-Arabi (l966) envisaged a banking system with mudaraba as the main pivot. He was actually advancing the idea of a two-tier mudaraba which would enable the bank to mobilize savings on a mudaraba basis, allocating the funds so mobilized also on a mudaraba basis. In other words the bank would act as a mudarib in so far as the depositors were concerned, while the 'borrowers' would act as mudaribs in so far as the bank was concerned. In his scheme, the bank could advance not only the capital procured through deposits but also the capital of its own shareholders. It is also of interest to note that his position with regard to the distribution of profits and the responsibility for losses was strictly in accordance with the Shariah.6 Irshad (l964) also spoke of mudaraba as the basis of Islamic banking, but his concept of mudaraba was quite different from the traditional one in that he thought of capital and labour (including entrepreneurship) as having equal shares in output, thus sharing the losses and profits equally. This actually means that the owner of capital and the entrepreneur have a fifty-fifty share in the profit or loss as the case may be, which runs counter to the Shariah position. Irshad envisaged two kinds of deposit accounts. The first sounded like current deposits in the sense that it would be payable on demand, but the money kept in this deposit would be used for social welfare projects, as the depositors would get zero return. The second one amounted to term deposits which would entitle the depositors to a share in the profits at the end of the year proportionately to the size and duration of the deposits. He recommended the setting up of a Reserve Fund which would absorb all losses so that no depositor would have to bear any loss. According to Irshad, all losses would be either recovered from the Reserve Fund or borne by the shareholders of the bank.

A pioneering attempt at providing a fairly detailed outline of Islamic banking was made in Urdu by Siddiqi in l968. (The English version was not published until l983.) His Islamic banking model was based on mudaraba and shirka (partnership or musharaka as it is now usually called). His model was essentially one based on a two-tier mudaraba financier-entrepreneur relationship, but he took pains to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic examples. He classified the operations of an Islamic bank into three categories: services based on fees, commissions or other fixed charges; financing on the basis of mudaraba and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

The issue of loans for consumption clearly presents a problem, as there is no profit to be shared. Siddiqi addressed this problem, but he managed only to scratch the surface. While recognizing the need for such interest-free loans (qard hasan), especially for meeting basic needs, he seemed to think it was the duty of the community and the State (through its baitul mal or treasury) to cater to those needs; the Islamic bank's primary objective, like that of any other business unit, is to earn profit. He therefore tended to downplay the role of Islamic banks in providing consumption loans, but he suggested limited overdraft facilities without interest. He even considered a portion of the fund being set aside for consumption loans, repayment being guaranteed by the State. He also suggested that consumers buying durables on credit would issue 'certificates of sale' which could be encashed by the seller at the bank for a fee. It was then the seller not the buyer who would be liable as far as the bank was concerned. However, the principles of murabaha and bai' muajjal were not invoked.

Strangely, Siddiqi favoured keeping the number of shareholders to the minimum, without advancing any strong reasons. This is contrary to the general consensus which now seems to have emerged with reference to Islamic banks operating on a joint stock company basis, a consensus which incidentally is also in line with the Islamic value attached to a broad equity base as against heavy concentration of equity and wealth. Ironically, Siddiqi thought that interest-free banking could operate successfully 'only in a country where interest is legally prohibited and any transaction based upon interest is declared a punishable offense' (l983b:l3). He also thought it important to have Islamic laws enforced before interest-free banking could operate well. This view has not gained acceptance, as demonstrated by the many Islamic banks which operate profitably in 'hostile' environments, as noted earlier.

Chapra's model of Islamic banking (Chapra l982), like Siddiqi's, was based on the mudaraba principle. His main concern, however, centered on the role of artificial purchasing power through credit creation. He even suggested that 'seigniorage' resulting from it should be transferred to the public exchequer, for the sake of equity and justice. Al-Jarhi (l983) went so far as to favor the imposition of a l00 per cent reserve requirement on commercial banks. Chapra was also much concerned about the concentration of economic power private banks might enjoy in a system based on equity financing. He therefore preferred medium-sized banks which are neither so large as to wield excessive power nor so small as to be uneconomical. Chapra's scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. He also spoke of non-bank financial institutions, which specialize in bringing financiers and entrepreneurs together and act as investment trusts.

Mohsin (l982) has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by banking business alone. Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Mohsin's model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that riba-free banks could coexist with interest-based banks. The point that there is more to Islamic banking than mere abolition of interest was driven home strongly by Chapra (l985). He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of riba, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a social-welfare-oriented rather than a profit-maximizing role. He conceived of Islamic banks as a cross-breed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers. Unlike conventional banks which depend heavily on the 'crutches of collateral and of non-participation in risk' (p. l55), Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing. Thanks to the profit-and-loss sharing nature of the operations, bank-customer relations would be much closer and more cordial than is possible under conventional banking. Finally, the problems of liquidity shortage or surplus would have to be handled differently in Islamic banking, since the ban on interest rules out resort to the money market and the central bank. Chapra suggested alternatives such as reciprocal accommodation among banks without interest payments and creation of a common fund at the central bank into which surpluses would flow and from which shortages could be met without any interest charges.

The literature also discusses the question of central banking in an Islamic framework. The general opinion seems to be that the basic functions of a modern central bank are relevant also for an Islamic monetary system, although the mechanisms may have to be different. Thus, for example, the bank rate instrument cannot be used as it entails interest. Uzair (l982) has suggested adjustments in profit-sharing ratios as a substitute for bank rate manipulations by the central bank. Thus, credit can be tightened by reducing the share accruing to the businessmen and eased by increasing it. Siddiqi (l982) has suggested that variations in the so-called 'refinance ratio' (which refers to the central bank refinancing of a part of the interest-free loans provided by the commercial banks) would influence the quantum of short-term credit extended. Siddiqi has also proposed a prescribed 'lending ratio' (i.e., the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) that can be adjusted by the central bank according to changing circumstances. In this context, reference may also be made to a proposal by Uzair (l982) that the central bank should acquire an equity stake in commercial banking by holding, say, 25 per cent of the capital stock of the commercial banks. The rationale behind this proposal was that it would give the central bank access to a permanent source of income so that it could effectively act as lender of last resort. The discussion of central banking in an Islamic context is somewhat scanty, presumably because Islamic central banking is viewed as too far-fetched an idea, except in Iran and Pakistan.

It emerges from all this that Islamic banking has three distinguishing features: (a) it is interest-free, (b) it is multi-purpose and not purely commercial, and (c) it is strongly equity-oriented. The literature contains hardly any serious criticism of the interest-free character of the operation, since this is taken for granted, although concerns have been expressed about the lack of adequate interest-free instruments. There is a near-consensus that Islamic banks can function well without interest. A recent International Monetary Fund study by Iqbal and Mirakhor (l987) has found Islamic banking to be a viable proposition that can result in efficient resource allocation. The study suggests that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts. The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope. But it is undeniable that the multipurpose character of Islamic banking poses serious practical problems, especially in relation to the skills needed to handle such diverse and complex transactions (Iqbal and Mirakhor l987).

The stress on equity-oriented transactions in Islamic banking, especially the mudaraba mode, has been criticized. It has been argued that the replacement of pre-determined interest by uncertain profits is not enough to render a transaction Islamic, since profit can be just as exploitative as interest is, if it is 'excessive' (Naqvi l98l). Naqvi has also pointed out that there is nothing sacrosanct about the institution of mudaraba in Islam. Naqvi maintains that mudaraba is not based on the Qur'an or the Hadith but was a custom of the pre-Islamic Arabs. Historically, mudaraba, he contends, enabled the aged, women, and children with capital to engage in trade through merchants for a share in the profit, all losses being borne by the owners of capital, and therefore it cannot claim any sanctity. The fact remains that the Prophet raised no objection to mudaraba, so that it was at least not considered un-Islamic.

The distribution of profit in mudaraba transactions presents practical difficulties, especially where there are multiple providers of capital, but these difficulties are not regarded as insurmountable. The Report of Pakistan's Council of Islamic Ideology (CII l983) has suggested that the respective capital contributions of parties can be converted to a common denominator by multiplying the amounts provided with the number of days during which each component, such as the firm's own equity capital, its current cash surplus and suppliers' credit was actually deployed in the business, i.e., on a daily product basis. As for deposits, profits (net of administrative expenses, taxes, and appropriation for reserves) would be divided between the shareholders of the bank and the holders of deposits, again on a daily product basis.

Literature: Practice

Recent years have brought an increasing flow of empirical studies of Islamic banking. The earliest systematic empirical work was undertaken by Khan (l983). His observations covered Islamic banks operating in Sudan, United Arab Emirates, Kuwait, Bahrain, Jordan, and Egypt. Khan's study showed that these banks had little difficulty in devising practices in conformity with Shariah. He identified two types of investment accounts: one where the depositor authorized the banks to invest the money in any project and the other where the depositor had a say in the choice of project to be financed. On the asset side, the banks under investigation had been resorting to mudaraba, musharaka and murabaha modes. Khan's study reported profit rates ranging from 9 to 20 per cent which were competitive with conventional banks in the corresponding areas. The rates of return to depositors varied between 8 and l5 per cent, which were quite comparable with the rates of return offered by conventional banks.

Khan's study revealed that Islamic banks had a preference for trade finance and real estate investments. The study also revealed a strong preference for quick returns, which is understandable in view of the fact that these newly established institutions were anxious to report positive results even in the early years of operation. Nienhaus (1988) suggests that the relative profitability of Islamic banks, especially in the Middle East in recent years, was to a large extent due to the property (real estate) boom. He has cited cases of heavy losses which came with the crash of the property sector.

The IMF study referred to earlier by Iqbal and Mirakhor (l987) also contains extremely interesting empirical observations, although these are confined to the experience of Iran and Pakistan, both of which have attempted to islamize the entire banking system on a comprehensive basis. Iran switched to Islamic banking in August l983 with a three-year transition period. The Iranian system allows banks to accept current and savings deposits without having to pay any return, but it permits the banks to offer incentives such as variable prizes or bonuses in cash or kind on these deposits. Term deposits (both short-term and long-term) earn a rate of return based on the bank's profits and on the deposit maturity. No empirical evidence is as yet available on the interesting question as to whether interest or a profit-share provides the more effective incentive to depositors for the mobilization of private saving. Where Islamic and conventional banks exist side by side, central bank control of bank interest rates is liable to be circumvented by shifts of funds to the Islamic banks.

Iqbal and Mirakhor have noted that the conversion to Islamic modes has been much slower on the asset than on the deposit side. It appears that the Islamic banking system in Iran was able to use less than half of its resources for credit to the private sector, mostly in the form of short-term facilities, i.e., commercial and trade transactions. The slower pace of conversion on the asset side was attributed by the authors to the inadequate supply of personnel trained in long-term financing. The authors, however, found no evidence to show that the effectiveness of monetary policy in Iran, broadly speaking, was altered by the conversion.

The Pakistani experience differs from the Iranian one in that Pakistan had opted for a gradual islamization process which began in l979. In the first phase, which ended on l January l985, domestic banks operated both interest- free and interest-based 'windows'. In the second phase of the transformation process, the banking system was geared to operate all transactions on the basis of no interest, the only exceptions being foreign currency deposits, foreign loans and government debts. The Pakistani model took care to ensure that the new modes of financing did not upset the basic functioning and structure of the banking system. This and the gradual pace of transition, according to the authors, made it easier for the Pakistani banks to adapt to the new system. The rate of return on profit-and-loss sharing (PLS) deposits appears not only to have been in general higher than the interest rate before islamization but also to have varied between banks, the differential indicating the degree of competition in the banking industry. The authors noted that the PLS system and the new modes of financing had accorded considerable flexibility to banks and their clients. Once again the study concluded that the effectiveness of monetary policy in Pakistan was not impaired by the changeover.

The IMF study, however, expressed considerable uneasiness about the concentration of bank assets on short-term trade credits rather than on long-term financing. This the authors found undesirable, not only because it is inconsistent with the intentions of the new system, but also because the heavy concentration on a few assets might increase risks and destabilize the asset portfolios. The study also drew attention to the difficulty experienced in both Iran and Pakistan in financing budget deficits under a non-interest system and underscored the urgent need to devise suitable interest-free instruments. Iran has, however, decreed that government borrowing on the basis of a fixed rate of return from the nationalized banking system would not amount to interest and would hence be permissible. The official rationalization is that, since all banks are nationalized, interest rates and payments among banks will cancel out in the consolidated accounts. (This, of course, abstracts from the banks' business with non-bank customers.) There are also some small case studies of Islamic banks operating in Bangladesh (Huq l986), Egypt (Mohammad l986), Malaysia (Halim l988b), Pakistan (Khan l986), and Sudan (Salama l988b). These studies reveal interesting similarities and differences. The current accounts in all cases are operated on the principles of al-wadiah. Savings deposits, too, are accepted on the basis of al-wadiah, but 'gifts' to depositors are given entirely at the discretion of the Islamic banks on the minimum balance, so that the depositors also share in profits. Investment deposits are invariably based on the mudaraba principle, but there are considerable variations. Thus, for example, the Islamic Bank of Bangladesh has been offering PLS Deposit Accounts, PLS Special Notice Deposit Accounts, and PLS Term Deposit Accounts, while Bank Islam Malaysia has been operating two kinds of investment deposits, one for the general public and the other for institutional clients.

The studies also show that the profit-sharing ratios and the modes of payment vary from place to place and from time to time. Thus, for example, profits are provisionally declared on a monthly basis in Malaysia, on a quarterly basis in Egypt, on a half-yearly basis in Bangladesh and Pakistan, and on an annual basis in Sudan.

A striking common feature of all these banks is that even their investment deposits are mostly short-term, reflecting the depositors' preference for assets in as liquid a form as possible. Even in Malaysia, where investment deposits have accounted for a much larger proportion of the total, the bulk of them were made for a period of less than two years. By contrast, in Sudan most of the deposits have consisted of current and savings deposits, apparently because of the ceiling imposed by the Sudanese monetary authorities on investment deposits which in turn was influenced by limited investment opportunities in the domestic economy. There are also interesting variations in the pattern of resource utilization by the Islamic banks. For example, musharaka has been far more important than murabaha as an investment mode in Sudan, while the reverse has been the case in Malaysia. On the average, however, murabaha, bai'muajjal and ijara, rather than musharaka represent the most commonly used modes of financing. The case studies also show that the structure of the clientele has been skewed in favor of the more affluent segment of society, no doubt because the banks are located mainly in metropolitan centres with small branch networks.

The two main problems identified by the case studies are the absence of suitable non-interest-based financial instruments for money and capital market transactions and the high rate of borrower delinquency. The former problem has been partially redressed by Islamic banks resorting to mutual inter-bank arrangements and central bank cooperation, as mentioned earlier. The Bank Islam Malaysia, for instance, has been placing its excess liquidity with the central bank which usually exercises its discretionary powers to give some returns. The delinquency problem appears to be real and serious. Murabaha payments have often been held up because late payments cannot be penalized, in contrast to the interest system in which delayed payments would automatically mean increased interest payments. To overcome this problem, the Pakistani banks have resorted to what is called 'mark-down' which is the opposite of 'mark-up' (i.e., the profit margin in the cost-plus approach of murabaha transactions). 'Mark-down' amounts to giving rebates as an incentive for early payments. But the legitimacy of this 'mark-down' practice is questionable on Shariah grounds, since it is time-based and therefore smacks of interest.

In the Southeast Asian context, two recent studies on the Bank Islam Malaysia by Man (l988) and the Philippine Amanah Bank by Mastura (l988) deserve special mention. The Malaysian experience in Islamic banking has been encouraging. Man's study shows that the average return to depositors has been quite competitive with that offered by conventional banks. By the end of l986, after three years of operation, the bank had a network of fourteen branches. However, 90 per cent of its deposits had maturities of two years or less, and non-Muslim depositors accounted for only 2 per cent of the total. Man is particularly critical of the fact that the mudaraba and musharaka modes of operation, which are considered most meaningful by Islamic scholars, accounted for a very small proportion of the total investment portfolio, while bai'muajjal and ijara formed the bulk of the total. It is evident from Mastura's analysis that the Philippine Amanah Bank is, strictly speaking, not an Islamic bank, as interest-based operations continue to coexist with Islamic modes of financing. Thus, the PAB has been operating both interest and Islamic 'windows' for deposits. Mastura's study has produced evidence to show that the PAB has been concentrating on murabaha transactions, paying hardly any attention to the mudaraba and musharaka means of financing. The PAB has also been adopting unorthodox approaches in dealing with excess liquidity by making use of interest- bearing treasury bills. Nonetheless, the PAB has also been invoking some Islamic modes in several major investment activities. Mastura has made special references to the qirad principle adopted by the PAB in the Kilu-sang Kabuhayan at Kaunlaran (KKK) movement launched under Marcos and to the ijara financing for the acquisition of farm implements and supplies in the Quedon food production program undertaken by the present regime. So far no reference has been made to Indonesia, the largest Muslim country in the world, with Muslims accounting for 90 per cent of a population of some 165 million. The explanation is that a substantial proportion, especially in Java, are arguably nominal Muslims. Indonesians by and large subscribe to the Pancasila ideology which is essentially secular in character. The present regime seems to associate Islamic banking with Islamic fundamentalism to which the regime is not at all sympathetic. Besides, the intellectual tradition in Indonesia in modern times has not been conducive to the idea of interest-free banking. There were several well respected Indonesian intellectuals including Hatta (the former Vice President) who had argued that riba prohibited in Islam was not the same as interest charged or offered by modern commercial banks, although Islamic jurists in Indonesia hold the opposite view. The Muslim public seems somewhat indifferent to all this. This, however, does not mean that there are no interest-free financial institutions operating in Indonesia. One form of traditional interest-free borrowing is the still widely prevalent form of informal rural credit known as ijon (green) because the loan is secured on the standing crop as described by Partadireja (1974). Another is the arisan system practiced among consumers and small craftsmen and traders. In this system, each member contributes regularly a certain sum and obtains interest-free loans from the pool by drawing lots. The chances of an Islamic bank being established in Indonesia seem at present remote (cf. Rahardjo 1988).

Finally, in the most recent contribution to the growing Islamic banking literature, Nien-haus (l988) concludes that Islamic banking is viable at the microeconomic level but dismisses the proponents' ideological claims for superiority of Islamic banking as 'unfounded'. Nienhaus points out that there are some failure stories. Examples cited include the Kuwait Finance House which had its fingers burned by investing heavily in the Kuwaiti real estate and construction sector in l984, and the Islamic Bank International of Denmark which suffered heavy losses in l985 and l986 to the tune of more than 30 per cent of its paid-up capital. But then, as Nienhaus himself has noted, the quoted troubles of individual banks had specific causes and it would be inappropriate to draw general conclusions from particular cases. Nienhaus notes that the high growth rates of the initial years have been falling off, but he rejects the thesis that the Islamic banks have reached their 'limits of growth' after filling a market gap. The falling growth rates might well be due to the bigger base values, and the growth performance of Islamic banks has been relatively better in most cases than that of conventional banks in recent years.

According to Nienhaus, the market shares of many Islamic banks have increased over time, notwithstanding the deceleration in the growth of deposits. The only exception was the Faisal Islamic Bank of Sudan (FIBS) whose market share had shrunk from l5 per cent in l982 to 7 per cent in l986, but Nien-haus claims that the market shares lost by FIBS were won not by conventional banks but by newer Islamic banks in Sudan. Short-term trade financing has clearly been dominant in most Islamic banks regardless of size. This is contrary to the expectation that the Islamic banks would be active mainly in the field of corporate financing on a participation basis. Nien-haus attributes this not only to insufficient supply by the banks but also to weak demand by entrepreneurs who may prefer fixed interest cost to sharing their profits with the banks.

Conclusion

The preceding discussion makes it clear that Islamic banking is not a negligible or merely temporary phenomenon. Islamic banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not subscribe to the Islamic injunction against the institution of interest, one may find in Islamic banking some innovative ideas which could add more variety to the existing financial network.

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. In practice, however, Islamic banks have been concentrating on short-term trade finance which is the least risky.

Part of the explanation is that long-term financing requires expertise which is not always available. Another reason is that there are no back-up institutional structures such as secondary capital markets for Islamic financial instruments. It is possible also that the tendency to concentrate on short-term financing reflects the early years of operation: it is easier to administer, less risky, and the returns are quicker. The banks may learn to pay more attention to equity financing as they grow older.

It is sometimes suggested that Islamic banks are rather complacent. They tend to behave as though they had a captive market in the Muslim masses who will come to them on religious grounds. This complacency seems more pronounced in countries with only one Islamic bank. Many Muslims find it more convenient to deal with conventional banks and have no qualms about shifting their deposits between Islamic banks and conventional ones depending on which bank offers a better return. This might suggest a case for more Islamic banks in those countries as it would force the banks to be more innovative and competitive. Another solution would be to allow the conventional banks to undertake equity financing and/or to operate Islamic 'counters' or 'windows', subject to strict compliance with the Shariah rules. It is perhaps not too wild a proposition to suggest that there is a need for specialized Islamic financial institutions such as mudaraba banks, murabaha banks and musharaka banks which would compete with one another to provide the best possible services.

Glossary

al-wadiah = safe keeping

bai'muajjal = deferred-payment sale

bai'salam = pre-paid purchase

baitul mal = treasury

fiqh = jurisprudence

Hadith = Prophet's commentary on Qur'an

hajj = pilgrimage

halal = lawful

haram = unlawful

ijara = leasing

iman = faith

mithl = like

mudaraba = profit-sharing

mudarib = entrepreneur-borrower

muqarada = mudaraba

murabaha = cost-plus or mark-up

musharaka = equity participation

qard hasan = benevolent loan (interest free)

qirad = mudaraba

rabbul-mal = owner of capital

riba = interest

Shariah = Islamic law

shirka = musharaka

Appendix

Islamic Financial Institutions (outside Pakistan and Iran)

Australia Islamic Investment Company, Melbourne.

Bahamas Dar al Mal al Islami, Nassau Islamic Investment Company Ltd, Nassau, Masraf Faisal Islamic Bank & Trust, Bahamas Ltd.

Bahrain Albaraka Islamic Investment Bank, Manama, Bahrain Islamic Bank, Manama, Bahrain Islamic Investment Company, Manama, Islamic Investment Company of the Gulf, Masraf Faisal al Islami, Bahrain.

Bangladesh Islamic Bank of Bangladesh Ltd, Dhaka.

Denmark Islamic Bank International of Denmark, Copenhagen.

Egypt Albaraka Nile Valley Company, Cairo, Arab Investment Bank (Islamic Banking Operations), Cairo., Bank Misr (Islamic Branches), Cairo, Faisal Islamic Bank of Egypt, Cairo, General Investment Company, Cairo, Islamic International Bank for Investment and Development, Cairo, Islamic Investment and Development Company, Cairo, Nasir Social Bank, Cairo.

Guinea Islamic Investment Company of Guinea, Conakry, Masraf Faisal al Islami of Guinea, Conakry.

India Baitun Nasr Urban Cooperative Society, Bombay.

Jordan Islamic Investment House Company Ltd Amman, Jordan Finance House, Amman, Jordan Islamic Bank for Finance and Investment, Amman.

Kibris (Turkish Cyprus) Faisal Islamic Bank of Kibris, Lefkosa.

Kuwait Al Tukhaim International Exchange Company, Safat., Kuwait Finance House, Safat.

Liberia African Arabian Islamic Bank, Monrovia.

Liechtenstein Arinco Arab Investment Company, Vaduz, Islamic Banking System Finance S.A. Vaduz.

Luxembourg Islamic Finance House Universal Holding S.A.

Malaysia Bank Islam Malaysia Berhad, Kuala Lumpur, Pilgrims Management and Fund Board, Kuala Lumpur.

Mauritania Albaraka Islamic Bank, Mauritania.

Niger Faisal Islamic Bank of Niger, Niamy.

Philippines Philippine Amanah Bank, Zamboanga.

Qatar Islamic Exchange and Investment Company, Doha, Qatar Islamic Bank.

Saudi Arabia Albaraka Investment and Development Company, Jeddah, Islamic Development Bank, Jeddah.

Senegal Faisal Islamic Bank of Senegal, Dakar, Islamic Investment Company of Senegal, Dakar.

South Africa JAAME Ltd, Durban.

Sudan Bank al Baraka al Sudani, Khartoum, Faisal Islamic Bank of Sudan, Khartoum, Islamic Bank of Western Sudan, Khartoum, Islamic Cooperative Development Bank, Khartoum, Islamic Investment Company of Sudan, Khartoum, Sudan Islamic Bank, Khartoum, Tadamun Islamic Bank, Khartoum, Jersey The Islamic Investment Company, St Helier, Masraf Faisal al Islami, St Helier.

Switzerland Dar al Mal al Islami, Geneva., Islamic Investment Company Ltd, Geneva, Shariah Investment Services, PIG, Geneva.

Thailand Arabian Thai Investment Company Ltd, Bangkok.

Tunisia Bank al Tamwil al Saudi al Tunisi.

Turkey Albaraka Turkish Finance House, Istanbul, Faisal Finance Institution, Istanbul.

U.A.E. Dubai Islamic Bank, Dubai, Islamic Investment Company Ltd, Sharjah.

U.K. Albaraka International Ltd, London, Albaraka Investment Co. Ltd, London, Al Rajhi Company for Islamic Investment Ltd, London, Islamic Finance House Public Ltd Co., London.

The list includes Islamic banks as well as Islamic investment companies but it does not include Islamic insurance or takaful companies.

Source: Siddiqi (l988)

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1 Surah al-Rum (Chapter 30), verse 39; Surah al-Nisa (Chapter 39), verse l6l; Surah al-Imran (Chapter 3), verses l30-2; Surah al-Baqarah (Chapter 2), verses 275-8l. See Yusuf Ali's Translation of the Qur'an.

2 Hadith compiled by Muslims (Kitab al-Musaqat).

3 This refers to a Hadith compiled by Muslims (Kitab al-Musaqat).

4 Bank Islam Malaysia Berhad has been offering a 70:30 profit-sharing ratio in favour of depositors (Man l988).

5 In l984 the Islamic Bank of Bangladesh offered rates of return ranging from 4.95 per cent to l4.l3 per cent. The Faisal Islamic Bank of Egypt, Cairo, gave a 9 per cent rate of return on deposits in the same year (Afkar Inquiry, December l985).

6 According to Sharia, profits arising from a mudaraba arrangement can be divided in any proportion between the two contracting parties as agreed upon at the time of the contract, but losses, if any, will fall on the financier only.

7 Some Muslim countries have recently introduced what are called 'Muqarada Bonds', the proceeds of which are to be used for income-yielding public utility projects such as the construction of bridges and roads. The bond holders will have a share in the collection of tolls and other receipts.

8 Qirad, sometimes also called muqarada, refers to a financial arrangement whereby the financier gets a share in the output, as in the case of Muqarada Bonds (see footnote 7). In the literature, the terms qirad and mudaraba are often used interchangeably.

9 The market shares of the Islamic banks are close to 20 per cent in Egypt, Kuwait and Sudan and roughly l0 per cent in Jordan and Qatar. By contrast, in Turkey, Islamic banks account for less than 1 per cent of the market (see Nienhaus 1988).

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Islamic Funding Structures And Financing Vehicles

*[This article was published in the 10th issue of **Nida'ul Islam** magazine, November-December 1995]*

Islamic banks around the world have devised many creative financial products based on the risk-sharing, profit-sharing principles of Islamic banking. For day to day banking activities, a number of financial instruments have been developed that satisfy the Islamic doctrine and provide acceptable financial returns for investors. Broadly speaking, the areas in which Islamic banks are most active are in trade and commodity finance property and leasing. Some of the basic financial techniques of Islamic banking are the following:

Murabaha: This is the sale of a commodity at a price which includes a stated profit known to both the vendor and the purchaser. This can be called a cost plus profit contract. The price is usually paid back by the buyer in deferred payments. Under Murabaha, the Islamic bank purchases, in its own name, goods that an importer or a buyer wants, and then sells them to him at an agreed mark-up. This technique is usually used for financing trade, but because the bank takes title to the goods, and is therefore engaged in buying and selling, its profit derives from a real service that entails a certain risk, and is thus seen as legitimate. Simply advancing the money to the client at a fixed interest rate would not be legitimate. It is important to note that only a legitimate profit in addition to the actual price is considered lawful under Islamic law. Any excessive addition on account of deferred payments will be disallowed as it would amount to a payment based on the value of money over time i.e. interest.

Mudaraba: This implies a contract between two parties whereby one party, the *rabb al-mal* (beneficial owner or the sleeping partner), entrusts money to the other party called the *mudarib* (managing trustee or the labour partner). The mudarib is to utilise it in an agreed manner and then returns to the rabb al-mal the principal and the pre-agreed share of the profit. He keeps for himself what remains of such profits. The following characteristics of mudaraba are of significance:

- The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump-sum or guaranteed return.
- The investor is not liable for losses beyond the capital he has contributed.
- The mudarib does not share in the losses except for the loss of his time and efforts.

Briefly, an Islamic bank lends money to a client - to finance a factory, for example - in return for which the bank will get a specified percentage of the factory's net profits every year for a designated period. This share of the profits provides for repayment of the principal and a profit for the bank to pass on to its depositors. Should the factory lose money, the bank, its depositors and the borrower all jointly absorb the losses, thereby putting into practice the pivotal Islamic principle that the providers and users of capital should share risks and rewards.

Musharaka: This is a partnership, normally of limited duration, formed to carry out a specific project. It is therefore similar to a western-style joint venture, and is also regarded by some as the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing in, and benefiting from, risk. Participation in a musharaka can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution.

In this case, the bank enters into a partnership with a client in which both share the equity capital- and perhaps even the management - of a project or deal, and both share in the profits or losses according to their equity shareholding.

Ijara Wa Iktina: Equivalent to the leasing and installment-loan, hire-purchase, practices that put millions of drivers on the road each year. These techniques as applied by Islamic banks include the requirement that the leased items be used productively and in ways permitted by Islamic law.

Muqarada: This technique allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqaradah bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.

Salam: A buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique, similar to a futures or forward-purchase contract, is particularly applicable to seasonal agricultural purchases, but it can also be used to buy other goods in cases where the seller needs working capital before he can deliver.

Besides their range of equity, trade financing and lending operations, Islamic banks world-wide also offer a full spectrum of fee-paid retail services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travellers' cheques, safe-deposit boxes, securities safekeeping investment management and advice, and other normal services of modern banking.

Almost every Islamic bank has a committee of religious advisers whose opinion is sought on the acceptability of new instruments and who have to provide a religious audit of the bank's end of year accounts.

The concepts of equity and morality are at the root of Islamic banking. In Islam moral and equitable values form an integral part of the rules of law governing contractual and financial relations to such an extent that the relationship which exists between equity, law and religion is an organic rather than supplementary relationship. The importance of Islamic banking has increased dramatically over the past 10 years. The main difference between Western and Islamic-style banking is the concentration on people and their businesses rather than on accounts- it is a much more 'grass roots' banking according to one expert.

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Islamic Investment in Australia

*[This article was published in the 10th issue of **Nida'ul Islam** magazine, November-December 1995]*

With the aim to present a practical model of Islamic banking to the Muslim community and to the Australian society at large, and to provide Muslims in Australia with an alternative to the existing interest-based financial products and services, Muslim Community Co-operative Australia was established in February 1989 with ten members and a starting capital of $22,300. Operating from its head office in Burwood, Victoria, MCCA's activities involve financial dealings and transactions based on Islamic finance principles. Transactions that involve interest are completely excluded from MCCA's activities. Its activities also include the provision of an institutional framework for converting the charitable funds into a socially beneficial and economically productive tool.

MCCA manages five types of funds: Murabaha, Musharaka, Mudaraba, Qard-el-Hassan and Zakat funds. It has enjoyed phenomenal growth since its inception and it currently contains more than 560 members with an asset base of $2,320,000 compared to only $105,700 in 1991. The rate of return on investment has jumped from 5.4% in 1991 to around 9.75% in 1995, a return which is much higher than fixed rate of return offered by interest-based banks.

In an interview conducted in October 1994, Peter Moody of the Australian Taxation Office summed up the activities and purposes of MCCA as follows:

1- A place for the advancement of the principles of the Muslim faith, and the evolution of a "community" that overlooks its members and shareholders. MCCA funds can be, and are used to help those in need within the community. Donations are received and applied for this purpose. A separate fund has been created for this end, and is known as the Qard Hassan Fund.

2- To operate as a housing co-operative that assists with the purchase of mainly residential properties for and on behalf of its shareholders. The purchase of other asset classes is undertaken in a similar fashion, mostly the purchase of motor vehicles, computers, and some limited business finance. The purpose of the provision of this facility is solely centred around the Muslim doctrine that forbids the payment of interest. MCCA charges an upfront "administrative" charge for their involvement, but thereafter, the loan is interest free. This conforms to all the requirements of their religion, and such transactions are held to be Halal, which means that they are "allowable" under Muslim doctrine. Repayments under these types of transactions are known as repayments of Murabaha.

3- To accept funds and issue shares in the co-operative from time to time, and to distribute the trading surplus of the co-operative back to the members in the form of dividends.

MCCA's objectives is to build up funds available for investment to $45 million; to educate and train on the concept and operations of Islamic Finance aiming to qualify at least 10 Muslims in managing and operating an Islamic Financial Institution: 5 in Victoria, 3 in NSW and 2 in WA; to open 3 branches for MCCA : 1 in Victoria, 1 in NSW and 1 in WA; and to establish and develop an institutional framework aiming for the best possible utilisation of charitable funds into economically productive and socially beneficial structure.

In a recent interview with the manager of MCCA, Br. Mohammed Nasser Abdel-Hakim, "Nida'ul Islam" posed some questions regarding its formation and functions.

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MCCA's contact numbers & address:
Tel: (03) 889 6644, Fax: (03) 889 1211
Head Office: 1342 Toorak Rd.
Burwood, Victoria, 3125
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Interview With The First Islamic Financial Institution in Australia, MCCA

*[This article was published in the 10th issue of **Nida'ul Islam** magazine, November-December 1995]*

Q. Can you introduce MCCA, its functions and how it started?

MCCA first started in February 1989. There were about nine Muslim youths in a study group, and I was explaining the conept of Islamic finance in contrast to the Riba-interest-system. We then decided to apply what we had learned.

We went through the procedures to incorporate the co-operative explaining to the officials how we were going to operate. They initially did not accept our proposal; but, however, when I explained to them that I was in the USA and I was involved in developing a similar organisation in USA and Canada, they looked more closely at our proposal and approved. All of the hassles were just because we wanted to put in the constitution that we are going to operate according to the Islamic code of life, that we are not going to operate according to the interest system.

Each type of financial service that is offered by the usury system (Riba System) we have an Islamic alternative for, and before we do anything we check our references- we check with the scholars (Ulama) and we make sure that what we do is according to Islamic Sharia'ah.

We have got three types of funds:

1) Mudaraba: which is mainly for business ventures;

2) Musharaka or Partnership: which is mainly in housing finance. The relationship between us and the house buyer is partners in the house. It is not a creditor to a debtor type of relationship, where the bank takes mortgage and puts the sword on the neck of the occupant saying: "you pay or else we kick out of the house." We don't sacrifice the security because our name will be on the title together with the buyer but we also give the buyer security that he or she will not be kicked out of the house in case of inability to pay us.

3) Murabaha: used for the purchase of any commodity - car, computer, furniture.

These are the main investment avenues that we use. But that's not the only Islamic tool of finance. To complete the cycle, to make the Islamic finance comprehensive we also have what we call Qard Hassan fund and we have Zakat and Charity funds. When you look at the picture you see that if I am in need to pay a hospital bill, for example, or some other kind of emergency, we feel and believe that we should not really take advantage of the weak position of the person and charge more. In this situation we hand out an interest free loan.

Q. So in fact you're trying to provide a microcosm of a bigger Islamic economic system which should be in existence...

That's right- so you help me without even knowing me by putting money into the organisation and I get money from the organisation.

Q. Where did you obtain the idea for this venture?

Actually the idea was clear in my mind when I went to the USA. In 1981, after finishing my MBA I was offered a job to be the finance director of one of the largest Islamic organisations in the USA - ISNA (Islamic Society of North America) and from that position then I had the opportunity to be involved in developing a sort of Islamic financial organisation in USA and Canada.

The ideas that I got from the USA from my position was not all-encompassing- it was just a start. The ideas started to mature in my mind and started to develop in my mind until the picture was very clear in my mind and all the activities that we now have in MCCA.

Q. Who actually supports MCCA?

Australian Muslims from all over Australia. We have at the moment 560 members from all over Australia- Sydney, Canberra, Melbourne, Darwin, Perth, and other states and territories. Also, we do have some investors from overseas, from students who used to be here and then went to Malaysia. So we are sort of a national organisation, not only a Melbourne organisation. In our future plans, within the next five years we would like to have a branch in Sydney, Perth and may be in Queensland because the community in Perth and Sydney are very active.

Q. Can you tell me how MCCA is different from other Investment Institutions that are founded in Australia?

The main difference is that we did not alhamdulillah deviate from the main goal when we started out as ten, or when we are 560 or when we become 5000. The main goal is to offer the Islamic alternative of finance to Muslims in Australia, and eventually to non-Muslims after we have full control over our operations. This area of finance is a very important area in the life of all people, so practising Islam in this area is a way of Da'wah, showing people that Islam is giving you an answer to your financial matters.

Any other organisation's main objective is the shareholder's equity, how much profit was made and so on. That's the big thing that all organisations are proud of whereas our pride is in introducing Islam through our specialised area.

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