Chapter I

INTRODUCTION
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1.1 Objectives of the Study

The primary objective of this study is to analyse the theoretical foundations of Islamic banking in the light of the experience of Islamic banks in Bangladesh. Scheme of analysis involves the main factors that have contributed to the emergence of Islamic banking in Bangladesh. The differences between the Islamic and conventional banking are critically examined in this study. Furthermore, it dealt with the problems, challenges and prospects of Islamic banking in Bangladesh from different perspectives. In dealing with these issues, the study aims to achieve the following objectives:

(1) To give a brief historical background on the origin and growth of Islamic banking and to explain the services they render, the products they use, and the functions they carry out.

(2) To identify the similarities and differences in the structure and practices of Islamic and conventional banks.

(3) To introduce the sources of shari'ah or Islamic legal system as the foundation for Islamic banking laws and regulations, which have shaped the evolution of modern Islamic finance.

(4) To examine the factors which have led to the emergence of Islamic banking with a brief review of the growth, development and future of Islamic banks in Bangladesh.
(5) To investigate the issue of the prohibition of *riba* (interest),\(^1\) from a legal and moral standpoint as enshrined in *al-Qur‘an* and the *sunnah*, and as prevalent in the literature on Islamic banking.

(6) To identify the challenges and problems in Islamic banking practice and evaluate the performance of Islamic banks in Bangladesh, and to suggest an approach to these challenges and problems.

(7) To offer some tentative suggestions on the subject based on the findings of the research.

1.2 Methodology of the Study

The methodology adopted for this study involves the following:

(1) The collection of material on Islamic banking and Islamic economics, from various sources both within and outside Australia.

(2) Survey of the available literature related to the research to analyse the theoretical aspects of the working mechanism of Islamic banking.

(3) Use of the two major sources of Islamic Law (*shari‘ah*) – namely *al-Qur‘an* and the *sunnah*.

(4) Examination of the secondary data on the subject through a study of dissertations, annual reports, journals, periodicals, bulletins, handouts, balance sheets, newspapers etc.

(5) A close observation of the operations, functions and associated problems of Islamic banking as well as of relevant practices of Islami Bank

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\(^1\) The term *riba* is used throughout this study as synonymous with interest and usury.
Bangladesh Ltd. as its Shari’ah supervisor for a substantial period of time.

1.3 Significance and Benefits of the Study

Islamic banking is a subject about which many people, including Muslims, know very little about. The theory of interest-free banking itself is a revolutionary idea in the banking business of a country. This aspect often gives rise to confusion and misconceptions about the operation of Islamic banking. The growth of Islamic banking partly reflects demand from Muslim clients for Islamic deposit facilities and fund management services which involve shari’ah compliance. At the same time, Islamic banking methods are viewed as a challenge and opportunity by conventional bankers, many of whom have sought to get involved in this growing industry. In client driven societies there is a willingness by those in financial services to learn from the experiences of Islamic banks. Further, the globalisation of trade necessitates the conducting of affairs of Islamic bank with non-Islamic banks, and vice-versa. Such integrated international trade demands that the business communities, banks and other trade regulatory bodies of both Muslim and non-Muslim countries should gain some understanding of the principles of Islamic banking. The knowledge of modern Islamic banking as compared to the conventional banking is very significant for economists, bankers, administrators and other peoples involved with international trade and commerce. Moreover, the increasing number of Islamic banks in various countries made it a necessity for banking communities to have some insight into the workings of Islamic banks.

Therefore, the present comparative research will familiarise the readers with the principles of shari’ah and will provide an insight into the rules and principles of Islamic
banking as well. In spite of the fact that the Islamic banks are operating successfully alongside other conventional banks and playing an increasing role in the economy, there has been little comprehensive research on Islamic banking in Bangladesh.

1.4 The Plan of the Study

The dissertation is divided into eight chapters. The first chapter is an introduction to the study. It explains the objectives, methodology, significance and plan of the study.

Chapter II provides the background to interest-free Islamic banking. In particular, it reviews Islamic and conventional banking, and provides a comparative analysis of these two systems. It discusses the concept, origins and history of interest, and provides a comparison of the Islamic and capitalistic concept of money and capital. It also discusses the notion of riba (interest) from a theological and philosophical point of view.

The third chapter is a broad introduction to Islamic shari'ah as the legal foundation of Islamic banking. It discusses elaborately the four major sources of shari'ah – the Islamic legal system i.e., Al-Qur'an, the Hadith or Sunnah, Ijma' and Qiyas. It summarises the characteristic features of an Islamic economy and its relationship to Islamic banking and finance. It also discusses the concept of ownership in Islam. The chapter concludes by illustrating the objectives and strategy of distributive justice from the Islamic point of view with special reference to the role of zakah in distributive justice.

Chapter IV focuses on the principles of shari'ah law in Islamic banking in general and on those principles for services, products and the operation of Islamic banks in particular.

Chapter V critically analyses the prohibition of riba in two primary sources of
shari'ah, and the modern controversies surrounding the interpretation of riba focusing on Modernists and Conservatives' views.

Chapter VI reviews and assesses the Islamic banking both in its theoretical and practical aspects. A brief literature survey is made in this regard. It also discusses the objectives and philosophy of Islamic banking. The chapter ends by outlining the problems and challenges faced by Islamic banking.

Chapter VII attempts to provide a general appraisal of Islamic banking in Bangladesh. To this end, after describing the factors which have led to the emergence of Islamic banking in Bangladesh, an attempt to evaluate the performance of some selected conventional and Islamic banks in Bangladesh is carried out, and some recommendations are made.

Chapter VIII of the thesis provides a summary and conclusion, and recommendations of the study. The thesis ends with the relevant appendices, glossary of Arabic terms and the bibliography.
Chapter II

INTEREST-FREE BANKING: A NEW PHENOMENON
2.1 The Background

Islam is not a religion in the common meaning of the word, confining its scope to the private life of an individual. It is a complete way of life, catering for all the fields of human existence. It provides guidance for all aspects of human behaviour including economic activities. As such, it casts a comprehensive look at the economic problems. God in Islam is the God of the entire world and the Prophet is a Messenger for the whole of mankind. According to the Islamic view, God has made the resources of this earth available to humanity who has the responsibility to make use of them, to mould them and transform them according to their needs. But humanity is supposed to observe certain limits in the exercise of their freedom. God created the universe and made humanity God’s vicegerent to use and develop the wealth in the best way to their benefit and well-being. This belief fills humanity with an enthusiasm to proceed continually in their pursuit to discover, understand, live and enjoy this world in a bid to prepare him for a life after death where human beings will be rewarded or punished according to their deeds. It is because of this basis, that Muslim jurists and scholars have built up the social, political and economic dimensions of an Islamic system. On the other hand, Islam has never discouraged Muslims from adopting other cultures, instruments, institutions, and the like, provided they are not incompatible with the fundamentals of the Islamic faith.

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2 Al-Qur’an, 1:1. Numbers appearing in the quotations from Al-Qur’an refer to its surah or chapter first, and then its ayah or verse. 1:1 would therefore, mean surah 1 or Al-Fatiha (The Opening Chapter) and ayah 1: “Praise be to Allah, The Cherisher and Sustainer of the Worlds”. These verses, however, are not always exhaustive; the same point may be supported by other verses as well.

3 Al-Qur’an, 7:158.
After the First World War the influence of Islam in the organisation of society has declined paving the way for segmentation of religion from public affairs. In the recent past, however, there has been increasing religious awareness throughout the Islamic world. This awareness has demanded the reorganisation of all social institutions according to Islamic principles. An important change is also taking place in the economic system of these countries including the banking sector. One of the important and significant requirements of the Islamic banking system is the prohibition of riba from the financial markets. Much effort has been devoted to eliminating non-Islamic elements from the functioning of the banking system. However, the institutions of interest dominate the economic environment in which Muslims live in modern times. Under such circumstances, it is extremely hard for Muslims to avoid interest-based transactions.

The debiting and crediting of interest, which is one of the major features of the modern financial system and central to financial operations all over the world, including the Muslim countries, is prohibited under the Islamic banking system for moral as well as economic reasons. In view of this unequivocal and categorical prohibition of riba, a society that is committed to establishing its socio-economic relations on Islamic values is bound to search for an alternative to the conventional banking system. The near-consensus amongst Islamic economists and jurists suggests that while Islam wants to discard all interest-bearing schemes in respect of loan/investment operations, it aims at establishing an economy where equity participation becomes the chief mode for financial operations.

However, the successful implementation of interest-free Islamic banking requires a clear understanding of its merits and demerits compared to the conventional system. To do so, one needs an analytical framework, which allows a comparison of the two systems. Moreover, the conventional banking system, though un-Islamic, is not without merit as it
satisfies the needs of those actively engaged in it. Knowledge of its merits would help evolve a system that would take into account these merits and assimilate them into an Islamic framework. Similarly, the interest-free Islamic banking system should not be taken as a cure for all economic ills, nor should the changeover be considered a costless and painless transition.

The Islamic system of variable return on financial contracts as opposed to fixed and pre-determined return of the conventional interest-based system has some stringent requirements, which place it in a disadvantageous position in the real world. The most crucial requirement turns out to be the ability of the financier to monitor the real performance of the project. The information requirements of this system are much more than those of the conventional system of fixed return. Since in practice the investor can monitor the performance of the project, while the financier has to incur some extra costs on monitoring, this asymmetrical information in the credit markets provides an incentive to the investor for under-reporting the results of the project. Since debt has the characteristic of minimising the informational requirements of a financial contract, it becomes a more attractive instrument of financing.

While comparing the two banking systems one will observe that the most important departure of Islamic banking system from the conventional banking system is the prohibition of *riba*, and the concentration on *bai‘* or selling and buying activities. Thus, if compared an Islamic bank with an existing conventional bank, one may say that while the latter earns the major profit of its revenues and expenses on the basis of interest, the former earns the same on the basis of profits arising from trade. Again, the former actually participate in production and commerce by taking an equity stake, whereas the latter’s interest in commerce and production is limited to the interest it can get in addition
to recovering the principal. Furthermore, Islamic banking is a risky business, but it is this risk sharing that justifies profit sharing and hence the return on capital in an Islamic system.

The shari'ah does not prevent Islamic banks from conducting transactions with conventional banks provided that the conventional banks follow the rules of shari'ah and structure their instruments or transactions accordingly. These conventional institutions should be encouraged and supported in such endeavours since they have the knowledge and experience to enrich the Islamic banking. They could introduce viable investment opportunities due to their large market and accumulated expertise. The entrance of such institutions increases competition, provides broader diversification of markets and risks, and better liquidity arrangements. It also allows wider interaction between conventional and Islamic systems, which will facilitate better understanding for both and lead to the globalisation of financial market.

The worldwide development of Islamic banking reveals that it has now become a US$50-$80 billion industry in terms of assets held, with about 300 interest-free Islamic banks currently active in more than 45 countries.\(^4\) In the early eighties, two countries viz. Pakistan and Iran established completely Islamic national banking systems, offering a range of sophisticated interest-free instruments and investment products. Elsewhere in Southeast Asia, Islamic banking has spread to Brunei, Indonesia and the Philippines. Islamic financial institutions are now found in most parts of the world including the United Kingdom, Scandinavia, North America and Africa. Besides, conventional western financial institutions have also begun offering Islamic financing products. Notable

examples include the London-based operations of Kleinwort Benson, Citibank and ANZ Grindlays, all of which structure and participate in billions of dollars of trade-financing arrangements annually for Muslim customers.

The impact of these happenings on the Muslims of the Peoples’ Republic of Bangladesh accounting for about 90 per cent of its 120 million estimated population has been tremendous. With the Islamic resurgence occurring all over the world, there have been attempts to set up an Islamic bank in this third largest Muslim country in the world. An Islamic bank thus appeared in Bangladesh in March 1983, for the first time in its history in the midst of conventional banks.

The development of Islamic banking in Bangladesh is a very interesting phenomenon. It is no exaggeration to say that it is the most exciting phenomenon in Islamic banking. Its rapid growth within unfavourable economic conditions has attracted the attention of many financial institutions in Islamic and Western countries. Five Islamic banks in the country including Islami Bank Bangladesh Limited (IBBL), which has over a hundred branches all over the country and the authorised capital of which is now 500,00 million Bangladeshi Taka, currently offer Islamic banking facilities. The paid up capital of the IBBL in 1983, was Taka 67.50 million, while it rose to 640.00 million Taka on June 30, 2001. In addition, its reserve fund was amounted to 0.36 million Taka at the end of 1983, which reached to 2074.88 million Taka on 30 June 2000. Beside these, two conventional banks continue to operate Islamic banking ‘windows’ side by side with conventional interest-based counters.

There are many factors that contribute to the successful growth of Islamic banking

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5 Bangladesh Bank – the central bank of the country traded one unit of USS at between Tk 58.40 and 58.52 as on 17-01-02. See, The Daily Independent (internet edition), Dhaka, January 20, 2002 issue (No. 1557).
7 Islami Bank Bangladesh Limited, Islami Bank: 18 Years of Progress, Dhaka, 2001, pp.4-5.
in Bangladesh, but its continued success will depend on its efficiency and profitability and its competitiveness with interest-bearing investments. The system must give proper consideration to the need to minimise the risk to customers and to the legitimacy of its operations from the *shari‘ah* point of view. The Bangladeshi experiment is fascinating and rich, illustrating the effectiveness of a pragmatic approach to solving the problems of Islamic banking.

### 2.2 Islamic and Conventional Banking: A Comparison

Banking in the form in which it exists today is comparatively of recent origin. Before the advent of modern banking, direct finance, where the owner of capital deals directly with the user of capital, was the customary mode of transference of funds from savers to investors. With the progress of trade and industry and increased financing requirements of productive enterprises, direct finance proved an inadequate mechanism for such transference and banks emerged on the scene to undertake financial intermediation between savers and investors. Furthermore, in modern times, they emerged as organisations that engage in any or all of the various functions of banking, i.e., receiving, collecting, transferring, paying, lending, investing, dealing, exchanging, and servicing money and claim to money both domestically and internationally.\(^8\) In its more specific sense, however the term bank refers to institutions providing deposit facilities for the general public.

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Perhaps the most striking feature in the structure of modern banking and finance is the use of credit institutions of accumulated wealth. Loans based on deposit funds provide financial support of the varied business and industrial enterprises in which men engage. Through credit, the accumulations of wealth, represented by bank deposits, have become a dynamic force in the modern world. Banking systems not only make the actual value of their deposit services available to society, but they have also multiplied the effective use of such funds by a system of discount and reserve which is of a comparatively recent origin.\(^9\)

Commercial banks perform all these functions and are considered to be the chief product of this age.

Therefore, the banks occupy very important position in a modern economy. Through the process of financial intermediation between savers and investors they exert immense employment and income generation effects, which ultimately help in economic advancement and social welfare. Another social welfare aspect of banks is through the provision of a return to the depositors, who are mainly small savers and include such weaker sections of the society such as widows, disabled orphans and the aged who could otherwise make no profitable use of their savings. Furthermore, the banks are manufactories of credit,\(^10\) which serves the community and keeps the wheels of commerce and industry revolving. By offering opportunities for investment and safe custody of deposits, they stimulate the habit of saving, and discourage hoarding or the unproductive use of surplus wealth, thus promoting investment and the growth of capital. A wise banking policy may go a long way towards mitigating the shocks of an economic crisis.

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\(^9\) Ibid., p.151.

while a banking system, if badly constructed or badly handled, is capable of inflicting
great harm on trade and industry and may even upset the whole economy.

The philosophical foundation of an Islamic financial system, where banking is the
most developed part of this system goes beyond the interaction of factors of production
and economic behaviour. Whereas the conventional financial system focuses primarily on
the economic and financial aspects of transactions, the Islamic system places equal
emphasis on the ethical, moral, social and religious dimensions, to enhance equality and
fairness for the good of society as a whole. The similarities between the two systems are
that in an Islamic system, banks, although controlled by the rules of shari'ah, essentially
perform the same functions as those in a conventional system; that is, they act as
administrators of the economy’s payments system and as financial intermediaries. They
are needed in both systems for the same reason — for the exploitation of imperfections in
financial markets. These imperfections include imperfect divisibility of financial claims,
imperfect information, transaction costs of search and acquisition, diversification by the
surplus and deficit units, and existence of expertise and economies of scale in monitoring
transactions.¹¹ Financial intermediaries in an Islamic system which operate in accordance
with shari’ah can reasonably be expected to exhibit economies of scale with respect to
these costs, as do their counterparts in a conventional system. Just as in the latter system,
the Islamic depository financial intermediaries transform the liabilities of business into a
variety of obligations to suit the tastes and circumstances of the surplus units.

Due to the nature of their operation, on the other hand, there are a lot of differences
between Islamic and conventional banking. Contrary to Islamic banking, conventional

banking has been defined as “accepting, for the purpose of lending or investing, deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise”. The Islamic banking has been defined by the International Association of Islamic Banks (IAIB) as “The Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic Shari`ah in the fields of finance and other dealings. Moreover the Bank functioning in this way must reflect Islamic principles in real life. The Bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious spirit among the people.” Thus, it is evident that Islamic banking is different from conventional banking in terms of its mission and objectives. Therefore, obligations of Islamic banking toward society are greater than conventional banks, for the following reasons:

a) Islamic banking has certain philosophical missions to achieve. That is, since God is the Creator and Ultimate Owner of all resources, institutions or persons have a vicegerency role to play in society. Therefore, Islamic banks are not free to do as they wish; rather they have to integrate moral values with economic action.

b) To provide credit to those who have the talent and the expertise but cannot provide collateral to the conventional financial institutions, thereby strengthening the grass-root foundations of society; and

c) To create harmony in society based on the Islamic concept of sharing and caring in order to achieve economic, financial and political stability.

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13 IAIB (The International Association of Islamic Banks), Directory of Islamic Banks and Financial Institutions, Jeddah, 2001.
The basic important departure of Islamic banking from conventional banking is the prohibition of *riba* and the promotion of *bai‘* or trade, which is evident from the following of *al-Qur’an*:

"Allah permits trade and forbids riba" (1:275).

Muslim jurists explain modern practice of *riba* as an additional sum, which is incorporated upfront (in advance) over principal sum of the loan and repayable over a specific period of time. This immediately leads us to the operations of Islamic banking that are conducted devoid of *riba*. From this perspective the major differences between the Islamic and conventional banking systems are as follows:

1. A conventional bank finances its customers based on the contract of loan where the bank is the creditor and the customer is the debtor. Thus, it is a creditor-debtor relationship. On the other hand, in an Islamic bank it is run by a contract of sale i.e., a deferred sale contract on which the bank itself, or the bank appoints the customer to, purchase the goods needed and later sells them to the client with a mark up (cost plus an agreed profit margin). The payment will be made in installments over a specified period of time.

2. An Islamic bank is said to make a legitimate profit from its trading activity as it involves risk and effort as compared to a conventional bank, which merely finances the customer at a fixed interest rate. An Islamic bank should be entitled to a profit because it has to buy the asset/commodity needed by the customer on a cash basis and the customer is obliged to pay more to the bank since the payment is deferred. It is a basic rule that one pay cheaper for cash as opposed to credit in which normally the price might have to be higher. Merely financing against fixed interest is said to be an unearned income and therefore it is an illegitimate profit.
3. The nature of Islamic banking is not merely lending the money as practiced by a conventional bank; rather it is involved in buying and selling the commodity/property. Thus the selling price, which is a cost price plus the profit margin, is the contracted amount. In conventional banking practice, interest is regarded as the price of the loan. For example, if the asset is worth of A$100,000 and the interest rate is at 10 per cent per annum, therefore, the price of the loan to be paid by the customer is A$110,000.

4. Profit margin imposed by an Islamic bank in some modes of investment e.g., in *murabahah* or cost plus profit is fixed at the time of contract and must be agreed upon by the customer. Once it is agreed upon and stipulated in the contract, it becomes and remains fixed throughout the duration of the agreed period of repayment. As a result, even if the client does not pay on time, the bank cannot ask for a higher price due to delay in settlement of dues. While interest rate, which is also prefixed at the time of contract either would be unchangeable or would change according to the Base Lending Rate (BLR) that constantly monitored by the Central of Bank.

5. Under Islamic banking system, no penalty is charged for late payment of installments. In order to get the Islamic type of financing, a customer needs to open an account with the bank and to deposit some amount of money in the account so that the deposited money could be set off in case of late payment. Nevertheless, if one has been a good paymaster to the extent that such security deposit has never been used, one is entitled to the dividends on the basis of profit and loss sharing principles. Furthermore, this deposit is merely for security reasons and it will be refunded at the end of repayment period. On the contrary, it is the usual practice of every conventional bank to charge penalty for late payment. There will be the compound interest. The longer the delay the bigger would be
the compounding effect. Due to this compounding activity, which has already given them profit, no security deposit is required by conventional banks.

6. In Islamic financing, no money is advanced to the clients by the bank. Instead, the bank, in *murabahah* for example, itself purchases the commodity required by the clients. Since these transactions cannot take place unless the clients assure the bank of their willingness to purchase a commodity, therefore, it is not possible at all, unless the bank creates inventory. In this manner, financing is always backed by assets.

7. Islamic banks face a risk not faced by their counterparts. Although both have to take credit risks, capital adequacy, liabilities and asset-matching risks, currency fluctuation and liquidity risks, the risk under Islamic banking system is higher. Because, in the case of the former where Islamic banks are organised mainly on the basis of profit earning arrangements permitted by Islam, both profit and loss are possible in every single deal, while in the case of lending at interest by their conventional counterparts the risk of loss is borne entirely by the borrower (the client), but the lender (the bank) safeguards himself/herself against any possibility of loss. However, some risks to which conventional banks are subject to do not exist in Islamic banks, for example, interest-rate risk, since interest is prohibited in their operations.

8. The focus of financial-accounting is different in Islamic banking. While in Islamic banks the emphasis is on asset allocation, and return from investment and trade, in conventional banks it is on interest-rate spread, provision of loan portfolios and maturities of the liabilities.\textsuperscript{14}

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9. Islamic banks and financial institutions cannot remain indifferent about the nature of the activity for which the facility is required. They cannot finance for any purpose which is prohibited in shari'ah. On the contrary, conventional banks are not bound by any religious restriction. Rather, these banks may advance loans for any profitable purpose. A gambling casino, for instance, can borrow money from a conventional bank to develop its gambling business.

In spite of the differences mentioned above between the Islamic and Conventional banks, both have something in common. Since Islamic banks do not rent money, and therefore do not charge interest, they have developed some investment techniques such as murabahah, musharakah and mudarabah in order to invest money and make profit. In any of these techniques, profitability and installment of repayment are identified beforehand. In additions, some Islamic banks practice certain forms of leasing. Many of the services handled by conventional banks and not related to interest, such as letters of credits, collections, foreign exchange, financial advising etc., are performed by Islamic banks. Some Muslim banks handle a large percentage of the Islamic bank’s money in the commodities markets. If it is considered that banks and financial institutions measure their success in terms of Returns on Assets (ROA), the commodity transaction can be developed to achieve the goals of the parties concerned – the Islamic bank, the conventional bank and the client of the conventional bank.\(^\text{15}\)

2.2.1 Operational Differences Between Islamic and Conventional Banking

The operational differences between Islamic and conventional banking are explained in this section by using a hypothetical example. For this purpose a model of financing a real estate is chosen. The normal procedure to finance the purchase of a house today in conventional banking is to apply for a mortgage. If the price is $100,000 for example, the bank may require a down payment equal to 10 percent of the appraised value. In case the appraised value and the purchase value are the same, the bank will require $10,000 down and lend the remaining $90,000. The buyer will sign a mortgage contract that will require monthly payments over a period of years. Typically, home mortgages run for a period of 15, 20, or sometimes as much as 30 years. The bank, of course, charges interest based on the amount of the unpaid principal, whose rate depends on prevailing market conditions and the term i.e., time period of the loan.

In conventional system if the bank agrees to give a 30-year mortgage for $90,000 at an annual interest rate of 8 percent for example, the monthly payments would be $660.39. Each payment will consist partly of interest due and partly the repayment of principal. Since the interest is figured on the basis of the remaining unpaid principal balance, the interest portion will decline over time while the principal portion increases. Over the 30-year period, the buyer will make 360 such payments, which add up to a total of $237,740.40 paid to the bank. This is more than two and a half times the $90,000 borrowed, accruing $147,740.40 interest to the bank.

If the buyers miss payments as scheduled a circumstance arisen for, the bank to foreclose and sell the house to recover the amount of principle and interest they still owe. The buyers may or may not recover any of their own investment. Since the bank's claim
has priority over the buyers, it will probably not try very hard to get the best price. The bank is mainly concerned about recovering its own investment, not the buyers’. So, it may set the selling price low in order to liquidate the property quickly, leaving little or nothing for the buyers to recover.

Contrary to the conventional arrangement the way Islamic banks apply to finance large purchases like houses or business enterprises, is *musharakah* or equity sharing. Just as in the conventional banks, the Islamic banks will require some down payment in equity sharing, which will be the buyers’ initial equity share. It can be the same down payment as was in the conventional system, i.e., 10 percent, or $10,000 in $100,000. The Islamic bank puts up the remaining $90,000. Now the buyers and the bank are co-owners. The buyers own 10 percent of the house and the Islamic bank owns 90 percent of the house. There is no interest to be paid on the Islamic bank’s capital but if the buyers occupy the house, they will be required to pay rent to the owners. Of course, since the buyers are part owners, part of the rent comes back to them. At the outset, the bank will get 90 percent of the rental payments and the buyers will get 10 percent. But the buyers are also allowed to increase their ownership share at any time by making additional payments to the Islamic bank, in effect, buying out the bank’s share in the house. As the buyers do so, their proportionate share increases while the Islamic bank’s share decreases and the distribution of the rent payments will change accordingly.

Now, this arrangement can be compared with the conventional mortgage in the example given above. The big question, of course, is what is a fair amount for the monthly rent? It might be reasonable to assume that it is equal to the monthly payments the buyers

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16 This is nothing new. It was common practice among the Dutch banks of the 13th century, a time when laws against usury were strictly enforced. It avoids usury by avoiding debt. For a detailed discussion see Thomas H. Greco, “How Does Halal Mortgage Compare With a Conventional Mortgage?” *Islamic Horizons*, London: September/October 1998, p.50.
would have made under the conventional mortgage arrangement, in this case, $660.39. At the outset, the buyers will receive 10 percent of that rent as their ownership share and the Islamic bank will receive 90 percent. It might be assumed also that the buyers apply their share of the rental payments to increasing their share of the ownership. Table 2.2.1 is an abridged amortisation table, which shows the respective returns to the buyers and the Islamic bank.

Table 2.2.1

Amortisation Schedule for a 30 Year Conventional Mortgage at 8% Interest; $90,000 Principal

<table>
<thead>
<tr>
<th>Payment Number</th>
<th>Monthly Payment</th>
<th>Interest</th>
<th>Principal</th>
<th>Balance after Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$660.39</td>
<td>$660.00</td>
<td>$60.39</td>
<td>$89,939.61</td>
</tr>
<tr>
<td>2</td>
<td>$660.39</td>
<td>$599.60</td>
<td>$60.79</td>
<td>$89,878.82</td>
</tr>
<tr>
<td>3</td>
<td>$660.39</td>
<td>$599.19</td>
<td>$61.20</td>
<td>$89,817.62</td>
</tr>
<tr>
<td>12</td>
<td>$660.39</td>
<td>$595.42</td>
<td>$64.97</td>
<td>$89,248.13</td>
</tr>
<tr>
<td>...</td>
<td></td>
<td>$527.13</td>
<td>$133.16</td>
<td>$78,951.84</td>
</tr>
<tr>
<td>120</td>
<td>$660.39</td>
<td>$527.13</td>
<td>$133.16</td>
<td>$78,951.84</td>
</tr>
<tr>
<td>240</td>
<td>$660.39</td>
<td>$384.83</td>
<td>$295.56</td>
<td>$54,428.98</td>
</tr>
<tr>
<td>...</td>
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<td>$384.83</td>
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</tr>
<tr>
<td>359</td>
<td>$660.39</td>
<td>$8.70</td>
<td>$651.69</td>
<td>$653.09</td>
</tr>
<tr>
<td>360</td>
<td>$660.39</td>
<td>$7.30</td>
<td>$653.09</td>
<td>$0.00</td>
</tr>
<tr>
<td>Totals</td>
<td>$237,740.40</td>
<td>$147,740.40</td>
<td>$90,000.00</td>
<td></td>
</tr>
</tbody>
</table>

Under this arrangement, the buyers will own 100 percent of the house after making the 350th payment, or in 35.67 years. The buyers will have paid total rent of $231,018.30. The bank’s total share will have been $141,018.30. This is a saving of more than $6,000 over the amount of interest paid on the conventional mortgage. In percentage terms, this is a saving of a little over four and one half percent. This may not seem like much, but, as one
shall see when he or she compares this approach with conventional mortgages carrying higher interest rates, the savings can be numerous.

A more important advantage derives from the risk sharing inherent in the shared equity approach. Under this arrangement, if the buyers are unable to make the scheduled principal payments, there is no foreclosure. The buyers simply do not add to their ownership share. If they are unable to pay the rent, however, they could be required to vacate the house, just as if they were renting from anybody else, but they would not lose their ownership equity. When the house is rented to someone else, the buyers would still receive their share of the rent, or if the house were to be sold, they would get their share of the proceeds based on the percentage of the equity which they own. Of course, since the Islamic bank’s claim does not take priority over the buyers, it is in the best interests of both the parties – the buyers and the bank to try to get the highest price possible for the house.

Compared to the conventional mortgage debt, the relationship between the buyers and the Islamic bank is amicable rather than antagonistic, where interests are congruent rather than opposed. The conventional mortgage being exploitative creates conflict, stress, and insecurity, while contributing to greater disparities of income and wealth. The shared equity financing, however, reduces conflict, stress and insecurity, and makes for a more harmonious and equitable society.
Table 2.2.2

Shared Equity with Rent Equal to Conventional 8%; 30 Year Monthly Payment; Owner’s Share Applied to Repurchase; No Additional Principal Payments

<table>
<thead>
<tr>
<th>Payment Number</th>
<th>Monthly Payment</th>
<th>Buyer’s Share</th>
<th>Islamic Bank’s Share</th>
<th>Buyer’s Equity</th>
<th>Buyer’s Equity %</th>
<th>Islamic Bank’s Equity</th>
<th>Islamic Bank’s Equity %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>$10,000.00</td>
<td>10%</td>
<td>$90,000.00</td>
<td>90%</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>$660.39</td>
<td>$60.04</td>
<td>$594.35</td>
<td>$10,066.04</td>
<td>10.07%</td>
<td>$89,933.96</td>
<td>89.93%</td>
</tr>
<tr>
<td>2</td>
<td>$660.39</td>
<td>$66.91</td>
<td>$593.91</td>
<td>$10,132.52</td>
<td>10.13%</td>
<td>$89,867.48</td>
<td>89.87%</td>
</tr>
<tr>
<td>3</td>
<td>$660.39</td>
<td>$66.91</td>
<td>$593.48</td>
<td>$10,199.43</td>
<td>10.20%</td>
<td>$89,800.57</td>
<td>89.80%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>$660.39</td>
<td>$76.83</td>
<td>$583.56</td>
<td>$11,711.34</td>
<td>11.71%</td>
<td>$88,288.66</td>
<td>88.29%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>120</td>
<td>$660.39</td>
<td>$144.54</td>
<td>$515.85</td>
<td>$22,030.94</td>
<td>22.03%</td>
<td>$77,969.06</td>
<td>77.97%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>240</td>
<td>$660.39</td>
<td>$318.43</td>
<td>$341.96</td>
<td>$48,536.24</td>
<td>48.54%</td>
<td>$51,463.76</td>
<td>51.46%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>359</td>
<td>$660.39</td>
<td>$652.52</td>
<td>$7.87</td>
<td>$99,461.37</td>
<td>99.46%</td>
<td>$538.63</td>
<td>0.54%</td>
</tr>
<tr>
<td>360</td>
<td>$660.39</td>
<td>$538.63</td>
<td>$3.56</td>
<td>$100,000.00</td>
<td>100.00%</td>
<td>$0.00</td>
<td>0.00%</td>
</tr>
<tr>
<td>Totals</td>
<td>$231,018.30</td>
<td>$90,000.00</td>
<td>$141,018.30</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To fully appreciate the advantages of the shared equity approach, one must examine the numbers pertaining to higher conventional mortgage interest rates. Table 2.2.3 shows the figures for conventional mortgages at 8%, 10%, and 12% interest, along with figures for comparable shared equity. It can be seen how seemingly small changes in the interest rate cause enormous increases in the amount of money the buyer must pay.
back. At 12% interest, for example, the buyer will repay $333,270.00 on his $90,000 loan over 30 years, giving the bank interest income of $243,270.00. However, a shared equity with the same monthly payment of $925.75 would give the buyers full ownership in 20.83 years. The total rent shares to the Islamic bank would be only $141,323.14, saving the buyer over $100,000.

Table 2.2.3
Conventional and Shared Equity Mortgage Summary

Conventional Mortgage
Comparative Figures of Different Interest rates
30 Year Conventional Mortgage: $90,000 Principal; $10,000 Down

<table>
<thead>
<tr>
<th>Interest Rate</th>
<th>Monthly Payment</th>
<th>Total Payback</th>
<th>Total Interest</th>
<th>Total Principal</th>
</tr>
</thead>
<tbody>
<tr>
<td>6%</td>
<td>$539.60</td>
<td>$194,256.00</td>
<td>$104,256.00</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>8%</td>
<td>$660.39</td>
<td>$237,740.40</td>
<td>$147,740.40</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>10%</td>
<td>$789.81</td>
<td>$284,371.60</td>
<td>$194,371.60</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>12%</td>
<td>$925.75</td>
<td>$333,270.00</td>
<td>$243,270.00</td>
<td>$90,000.00</td>
</tr>
</tbody>
</table>

Shared Equity
$90,000 Initial Bank Equity (90%); $10,000 Initial Buyer’s Equity (10%)
Buyer’s share of monthly rent applied to repurchase of bank’s share

<table>
<thead>
<tr>
<th>Total Payment</th>
<th>Monthly Rent</th>
<th>Total Payout</th>
<th>Bank’s Share of Rent</th>
<th>Principal</th>
<th>Payment required to complete buyout</th>
<th>Years required to complete buyout</th>
</tr>
</thead>
<tbody>
<tr>
<td>$539.60</td>
<td>$230,879.35</td>
<td>$140,879.35</td>
<td>$90,000.00</td>
<td>428</td>
<td>35 2/3</td>
<td></td>
</tr>
<tr>
<td>$660.39</td>
<td>$231,018.30</td>
<td>$141,018.30</td>
<td>$90,000.00</td>
<td>350</td>
<td>29 1/6</td>
<td></td>
</tr>
<tr>
<td>$789.81</td>
<td>$231,167.29</td>
<td>$141,167.29</td>
<td>$90,000.00</td>
<td>293</td>
<td>24 5/12</td>
<td></td>
</tr>
<tr>
<td>$925.75</td>
<td>$231,323.14</td>
<td>$141,323.14</td>
<td>$90,000.00</td>
<td>250</td>
<td>20 5/6</td>
<td></td>
</tr>
<tr>
<td>$789.81</td>
<td>$660.39</td>
<td>$167,562.16</td>
<td>$77,562.16</td>
<td>$90,000.00</td>
<td>213</td>
<td>17 4/5</td>
</tr>
<tr>
<td>$925.75</td>
<td>$660.39</td>
<td>$144,481.83</td>
<td>$54,481.83</td>
<td>$90,000.00</td>
<td>157</td>
<td>13 1/12</td>
</tr>
</tbody>
</table>

The figures in this table assume that the fair rent in each case is equal to the mortgage payment. That assumption, however, may be too far fetched. It might be assumed that in every case, the fair rent is equal to the mortgage payment at 8 percent, or
$660.39. Under these circumstances, any amount paid over and above that figure would be directly applied to increasing the buyers' equity share rather than being split between them and the Islamic bank. The lower part of the Mortgage Summary Table (Table 2.2.3) shows the figures for monthly payments equivalent to those at the 10 and 12 percent mortgage rates. With payments of $789.81, the buyers will achieve complete ownership in 17.75 years. The bank's share of total rents will be only $77,562.16. With payments of $925.75, the buyers will achieve complete ownership in only 13.08 years, having paid the bank rent shares of only $54,481.83, saving the buyers almost $189,000 or 77.6 percent over the conventional mortgage with the same monthly payment.

2.3 Concept of Interest: Origins and History

The term 'interest' means "the extra money that one pays back when one borrows money or that one receives when one invests money".\(^{17}\) In other words, "money paid for the use of money lent, or for not requiring the repayment of a debt".\(^{18}\) But 'interest' is defined by Boehm-Bawerk as "the income that flows from capital".\(^{19}\) He defines capital as 'a complex of goods that originate in a previous process of production'.\(^{20}\) However, interest offers enormous resources to answer the borrowers' need for capital. The savers receive one rate of interest as a reward for their savings and a reward for parting with their liquid cash, and the borrowers pay another rate of interest as the price for using the new monetary resources. The difference between these two rates is what the monetary agents

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earn against their time and labour. In this manner, what puts the machinery of the monetary system into motion is interest, upon which the whole structure is based.

There were two major concept of the practice of interest in the history of ancient civilisation:

(i) the biological concept of interest, and

(ii) the compensatory concept of interest.

I. The Biological Concept of Interest

The biological concept of interest originated in Near Eastern societies which regarded credit as alive like plants, animals and people, and therefore capable of reproducing itself.\(^{21}\) This concept arose from loans of seeds and animals. The seeds yielded much larger harvests. Domestic animals multiplied; some part of all of the animal’s progeny could be returned for the animal. Since loan could be used for productive purposes, interest was considered legitimate. A similar biological image of real capital as a phased collection of maturing consumables was invoked by Bohm-Bawerk.\(^{22}\) The doctrine of usury in the Middle Age was a revolt against this biological concept. The Latin *usura* means the use of anything, in this case the use of borrowed capital. Hence usury referred to the price paid for the use of money.\(^{23}\) This doctrine maintained that loans do not necessarily lead to an increase in production. There was, therefore, no justification for paying more than what is given.

II. The Compensatory Concept of Interest

The compensatory concept of interest claims that interest is not a net gain, but rather compensation due to a creditor because of a loss which he or she was likely to incur through lending. Literally, the Latin verb *interesse* means to be lost, and the modern term ‘interest’ was a derivative of this verb. In deed, according to some scholars, compensation for default risk is the most important reason for interest in a primitive society. As John Hicks points out:

“It is easy to see that if there is any doubt about repayment there must be interest, for no one will voluntarily part with money, as a commercial transaction, in return for anything less than a 100 percent probability of the principal being repaid”.

The compensatory concept of interest was enshrined in Roman Law, where interest was considered as the difference between the lenders’ or other injured party’s present position and that in which they would have stood if they had not loaned.

2.4 Interest from the Philosophical and Religious Point of View

The practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions. Under Judaism, Israelites were forbidden to demand any increase on the principal amount of the sum lent in transactions among themselves though interest could be charged in dealings between Israelites and gentiles. The reason for this distinction, according to many scholars of Judaism, was that there was no law at that time among the gentiles which prohibited the practice of interest, and it was not regarded as

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unfair that Jews be allowed to recover interest from people who charged interest from them. In the Christian religion, interest was originally prohibited. The reported saying by Christ to “lend freely, hoping nothing thereby” (Luke 6:35) is taken by many commentators as condemnation of interest. Religious authorities continued to defend the prohibition until the sixteenth century when ideas on the illegality of interest differed and the growth of business forced religious scholars to change their viewpoint. In broad sense, with the increasing domination of commercial capital and the expansion of credit transactions and business life, payment of interest was recognised gradually, and in the latter stage of industrial development it was regarded as necessary. In any case, the separation between religion and mundane affairs accepted by Christian societies after Renaissance opened the door for widespread practice of interest.

In ancient Greece and Rome, the outright opposition to interest came from the philosophers and moralists. The Roman philosophers were unanimous in their opposition to interest on moral grounds. However, two ancient philosophers Aristotle and Seneca had significant influence on the issue of interest.26

Seneca – a Roman philosopher considered interest to be morally wrong because it involved paying for time. On the contrary, Aristotle a Greek philosopher distinguished between wealth of two kinds: natural wealth, to him an organic concept - which is the result of human effort combined with raw materials; and unnatural finance, brought about by the introduction of the currency system to effect exchange. Aristotle saw finance as an evil art, the most evil form of which was interest. This was because coin, an inorganic object, whose only proper function was that of a medium of exchange, cannot breed coin

and was therefore barren. Thus, according to Aristotle, interest is the result of the unnatural use of money and is contrary to natural law. The basis of Aristotle’s position is that money is sterile and cannot bear, and indeed ought not to bear, interest.\(^\text{27}\) Aristotle also dealt with the concept of economic duress and the concept of just equivalence.

The opinions of these two philosophers had a considerable impact on medieval thought, which was an intellectual reconciliation of philosophy (mainly Greek) with the Christian faith. Seneca’s opinion became a vital element in the analysis of prohibition, but the impact of Aristotle’s idea was much greater. It was on these foundations that the medieval ban of interest depended.\(^\text{28}\)

In fact, the prohibition of interest was not unusual to the secular or Christian writings in the Medieval ages. Interest was condemned by Jews in the Old Testament. The Greek and Roman Laws, while not prohibiting interest altogether, regulated it. More critical is the ban imposed on interest by Islam. This is crucial both for the sake of comparison and for the purpose of this study, which aims at identifying an appropriate alternative for the contemporary interest-based financial system. The shari‘ah opinion on the subject of riba or interest/usury is explained in chapter 5 of this study more elaborately.


2.5 Islamic Concept of Money and Capital

As compared with capitalism, Islam has a specific view with regard to money. Money is, on one hand, forbidden to be accumulated and, on the other hand, is forbidden to be squandered it lavishly. Given these two limits, it is observed that the banking method of capitalist society using money – either in raising or lending it based on the system of interest is, as much as regards the objective, totally conformant with the general intentions of shari'ah. Because Islam treats money as a medium of exchange but not as a commodity, since money by itself cannot perform any function. It becomes useful only when it is exchanged into a real asset or when it is used to buy a service. Therefore, it cannot be sold or bought on credit. Prophet Muhammad (peace be upon him) who was guided by revelation, not only declared interest on loan as unlawful but also banned exchange of money and some other valuables for an unequal quantity and on deferred payment basis if the commodity or currency was the same.\(^\text{29}\) Interest is nothing more than usury. For instance, alcohol is forbidden; that which intoxicates is banned regardless of the quantity consumed. Similarly, usury is a twin of alcohol in spoiling the intentions of the shari'ah in people; little of it is banned and sinful just like much of it. Where the human body is able to bear a diluted sip of a certain quantity of the deadly poison, such capability of forbearance does not mean one can say that poison, as it did not kill any particular youngster.\(^\text{30}\)


As far as the capital is concerned, Islam recognises capital and its role in the process of production. Islam recognises its share in national wealth only to the extent of its contribution, to be determined as a variable percentage of the profits earned rather than a fixed percentage of the capital itself. Because, in Islam, capital is productive in the sense that labour assisted by capital produces more than without capital. Again, profits, which are allowed by Islam, are the result of investments in production, which is a time consuming process. It is the profit motive, which induces an individual to save and invest and thereby postpone present consumption to a future date. Thus the Islamic concept of capital seems to be more realistic, more comprehensive and more ethical than the modern concepts of capital. It is realistic, because the productivity of capital, which is subject to change, is related to the realities of production, which is supposed to be mobile in the dynamic setting of growth. It is comprehensive, because it takes note of all variables like currency, population, inventions, habits, tastes, living standards, time-lag and so on. It is ethical, because the variable share or capital in an Islamic society must be just and equitable and must be free of exploitation of other agents of production, which contribute to the creation of national wealth.\footnote{Mannan, M. A., \textit{Islamic Economics: Theory and Practice}, Delhi: Idarah-i-Adabiyat-i-Delhi, 1980, p.165.} Therefore, in the Islamic social framework fixed interest on capital is not allowed to exercise its harmful effects on the economy.
Chapter III

*SHARI`AH: THE LEGAL FOUNDATION OF ISLAMIC BANKING*
SHARI‘AH: THE LEGAL FOUNDATION OF ISLAMIC BANKING

3.1 What Islam Stands For?

Islam is a complete way of life. It is the guidance provided by God - the Creator of the universe, for all mankind. ‘Islam’ is an Arabic word, which is from the root s.lm. This literally means ‘to surrender’, ‘to submit’, ‘to yield’ ‘to give one’s self over’. Therefore, Islam stands for complete submission and obedience to one God whom Islam calls Allah - the Lord and the Sovereign of the Universe. The other major shade of meaning in the root is ‘to become reconciled with one another’, ‘to make peace’, 32 which signifies that one can achieve real peace of body and mind only through submission and obedience to God. Such a life of obedience brings peace of the heart and establishes real peace in society in large.

As a religion, Islam stands for belief in one God and in all prophets of God from Adam to Muhammad (pbuh) 33, the last Prophet. A Muslim is one who submits himself or herself to the Will of God and thereby professes the faith of Islam. A Muslim therefore believes in all the prophets and makes no distinction between one and the other. He or she also believes that God - the Lord of the universe raised God’s prophets from among human beings to all corners of the earth to preach the same religion, and that the message received by the last prophet Muhammad (pbuh) is the most comprehensive and the final form of God’s message to the entire humanity. 34

33 This is an abbreviation of ‘peace and blessings of God be upon him’ - a Muslim must repeat the saying whenever Prophet Muhammad’s name is mentioned.
34 Al-Qur‘an, 3:83, see also 2:136, 3:3-4, 42:13.
Islam, as it has been declared by *al-Qur’an*, is the perfect religion and completion of God’s favour upon humanity so far as the regulation of their lives are concerned.\textsuperscript{35} For a Muslim, religion posits the ideal of a life in which, from the cradle to the grave, not a single moment is spent out of tune with or merely unprovided for by a religious ruling. In other words, no sphere is left in which the thoughts and deeds of a Muslim both in his or her personal and public life are inconsequential for his or her fate in the life after death. That is why God exhorts people to accept Islam in its entirety.\textsuperscript{36} It means that the whole life of a person in all its spheres should be an expression of complete submission to God, the Rightful Master.

The conception of ‘*ibadah* or worship in Islam is not restricted to the purely devotional practices, but extends over the whole of Muslim’s practical life as well. It implies that only by obeying the commands of God one proves his or her fidelity and loyalty to God. Thus, all actions of a person even the seemingly trivial ones, must be performed as acts of worship; that is, performed consciously as constituting a part of God’s universal plan. Islam knows no distinction between the religious and secular; rather it views in one sweep the entire life of mankind. The philosophy of ethics, laws and morals, manners and mores, forms of social, political and economic organisation side by side with the problems of worship and theology – have their legitimate place in the all-inclusive system of Islam. God who is the Sustainer and the Nourisher of this world and has created resources to maintain it and lead it to perfection, has also given Islam – a complete code of life by following which a person can find peace and happiness in this world and the world to come.

\textsuperscript{35} *Al-Qur’an*, 5:4.
\textsuperscript{36} *Al-Qur’an*, 2:208.
A person joins the fold of Islam by honestly believing in and professing faith in tawhid or singularity of God and in risalah or affirming the prophethood of Muhammad (pbuh). In a broad sense, tawhid means there is none worthy of worship except God – the Supreme Lord of the universe. God’s dominion includes all human beings, all those that God has created. This belief is not only the starting point of Islam, but also constitutes the essence of its teachings. It points the supremacy of the law in the universe, the all-permeating unity behind the manifest diversity. It means that all human beings are the creatures of one and they are all equal. Discrimination between colour, class, race or territory has no foundation. Human being is one single family of God and there can be no sanction for those barriers. Islam gives a revolutionary concept of the unity of mankind. The concept of tawhid also defines the true position of human kind in the universe. It says that God is the Creator, the Absolute Sovereign; and that human being is God’s vicegerent on the earth. This exalts human being to the dignified position of being God’s deputy on earth and endows their lives to fulfill the Will of God on earth. This will establish a new order wherein peace and justice will reign supreme.

Risalah – the second basic principle of Islam signifies that God has not left human beings without any guidance for the conduct of their lives. To direct them along the proper path, God revealed through God’s prophets the codes of conduct, or the Shari’ah, the precise application and observance of which guaranteed individuals felicity in this world and salvation in the hereafter or life after death. They have translated their mission into practice in their own lives and in the society they tried to reform. All the prophets were human beings and representatives of God, and their lives were models for mankind.

37 Al-Qur’an, 57:5; 67:1.
38 Al-Qur’an, 2:30-39.
Muhammad (pbut) was the last prophet of God and as such the final model for mankind. Belief in the prophet involves acceptance of his authority as representative of God and following his example in thought and practice as well as implementing that in all walks of life. The test of acceptance of God and prophet lies in conducting all human affairs in accord with the Law revealed by God.\(^{39}\) Thus, belief in God and God’s prophet means commitment to obey them and to approach individual and collective life in the light of the Law and Guidance provided by them.

Islam views the world as a place of trial and human beings will have to give account of all that they do herein. It will be in that Life-after-death that they will be rewarded with eternal bliss if they live the present world a life of obedience to the Lord, or they will be punished if they disobey God’s commands.\(^{40}\) Thus, the basic articles of Islamic faith are as follows:

a. Belief in the Unity of God;

b. Belief in the Prophethood of Muhammad (pbut); and

c. Belief in the life after death and in individual’s accountability before God on the Day of Judgment.

Whoever believes and professes these fundamental articles of faith joins in the fold of Islam and is considered as a ‘Muslim’.

The distinct features of the Islamic code of life can be summed up as follows:

**Firstly**, Islam is a practical system of life that fully appreciates all the genuine requirements of mankind and attempts to realise them.

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\(^{39}\) Al-Qur’an, 5:44.

\(^{40}\) Al-Qur’an, 17:13-14; see also 6:160.
Secondly, it effects a balance between all areas of life and activity. It also strikes a balance between different sectors of society and between different aspects of existence be it spiritual or material.

Thirdly, Islam guarantees personal freedom and provides opportunities for individual enterprise but not at the cost of society or ideals of social justice. It retains all the good characteristics of other systems, yet is free from their shortcomings.

These are some salient features of Islam that are sufficient to show that a comprehensive religion with such laws and principles cannot lose its usefulness for mankind.

3.2 The Sources of Shari'ah

The rules and norms of Islam derive from shari'ah. It encompasses the whole body of ethical and legal rules elucidated through the discipline of fiqh or Islamic jurisprudence. Therefore, it is impossible to adequately treat Islamic banking without viewing this institution in the context of Islam as an entire socio-economic system and, consequently, relating it to Islamic Law.

The etymological meaning of the Arabic word shari'ah is the ‘path leading to the water’ and thus the verb shara'a literally means ‘to chalk out or mark out a clear path to water’.\(^{41}\) In its religious usage it has meant ‘the way which directs a person’s life to the right path’.\(^{42}\) In other words, shari’ah is the path not only leading to God, but also the path


believed by all Muslims to be the path shown by God, through God’s Messenger, Prophet Muhammad (pBUH). In Islam, God alone is the sovereign and God alone has the right to ordain a path for the guidance of mankind. Thus, it is only shari‘ah that liberates human beings from servitude to other than God. Muslims are obliged to strive for the implementation of that path, and that of no other path.44

The concept of shari‘ah not only governs human beings in conducting their lives in order to realise the divine will, but it includes all forms of human activities be it spiritual, mental or physical. Therefore, the shari‘ah principles are more than law, not only covering the total way of life that includes both faith and practices, but also all personal behaviour, legal and social transactions.45 Shari‘ah comprises all that might be positively called law. It unites and guides Muslims in both time and space, and gives Muslims a profound sense of security and stability.46

The role of Islamic law in defining the broad outlines of the Islamic economic system is similar to the role of any other legal system in shaping an economic system. However, laws in non-Islamic societies are made, modified, altered and annulled by the collective will of individuals in society and are therefore subject to change, whereas laws in Islamic societies are supposedly divinely ordained and hence immutable, eternal, beyond human modification. In Islamic society, it is not possible to promulgate laws that infringe the `ibadat, the divine laws concerning religious practices and duties, the `uqbat, the laws concerning Islamic punishments, or the munakahat, the Islamic civil and family laws. It is only in the field of mu‘amalat, financial transactions, or those areas in which no clear stipulation has already been made in al-Qur‘an and the Sunnah, that human beings

43 Qutb Sayyid, Hadha al-Din, Beirut, undated, p.19.
44 Al-Qur’an, 65:18.
can legislate, and even then under the strict condition that such laws should not anyway contradict, oppose or challenge pre-ordained divine laws.\textsuperscript{47}

Even though human reason and judgment thus have only a limited role in the legislation of an Islamic society, it is important to point out that the Islamic legal system is not considered absolutely rigid and static. The differences between Islamic schools of thought do not concern the basic principles of the \textit{shari'ah}, but subsidiary inclusions or additions to the body of \textit{fiqh}.\textsuperscript{48}

The \textit{shari'ah} not only provides society with a collection of laws which indicates the right path, it also focuses on specific human activities and classifies them according to their degree of desirability from God’s perspective. Every activity is therefore either \textit{fard} or \textit{wajib}, the obligatory; \textit{mandub} or \textit{mustahab}, the recommended; \textit{ja'iz} or \textit{mubah}, the permitted or left legally indeterminate; \textit{makruh}, the reprobated; or \textit{haram}, the forbidden and prohibited.\textsuperscript{49} The determination of the legality or illegality, permissibility or impermissibility of an act requires the \textit{faqih}\textsuperscript{50} or jurisconsult to search for \textit{adillah}\textsuperscript{51} (plural of \textit{dalil}), the proofs or evidences in the valid sources of Islamic jurisprudence. The science of \textit{shari'ah} reflects the result of the process of compilation, authentication, categorisation and arrangement of each and every authoritative judgment of the \textit{fuqaha} (plural of \textit{faqih}) in every conceivable field.

\textit{Shari'ah} is derived mainly from four sources or roots. They are, according to their authoritative value: \textit{Al-Qura'n}, \textit{Hadith}, \textit{Ijma'} and \textit{Qiyas} or \textit{Ijtihad}. \textit{Al-Qur'an}, the first

\textsuperscript{48} Muslim Jurisprudence that covers all aspects of life, religious, political, social or economic. The whole corpus of \textit{fiqh} is based primarily on the \textit{Qur'an} and the \textit{Sunnah} and secondarily on \textit{i'jma'} and \textit{ijtihad}.
\textsuperscript{49} Musleh-ud-din, M. \textit{Philosophy of Islamic Law and the Orientalists}, New Delhi, 1986, p.65.
\textsuperscript{50} The authoritative judge of the science of \textit{shari'ah}; Muslim jurist.
\textsuperscript{51} These are the sources on which the \textit{shari'ah} is constructed and from which it obtains its legitimacy.
primary source of *shari‘ah* constitutes messages that God revealed to Prophet Muhammad (pbuh) through the Angel Gabriel to relay for the guidance of mankind. These messages are universal, eternal and fundamental. The *hadith*, the second foundation of *shari‘ah*, is next in importance to *Al-Qur‘an*. The sayings and practice of Prophet Muhammad (pbuh) known also as the *sunnah* of the Prophet, handed down from generation to generation and which have become the rules of faith and practice of Muslims. The *sunnah* signifies the customs, habit or usage of the Prophet. It designates his behaviour, mode of action, his saying and declaration under a variety of circumstances in life. The third source of *shari‘ah* is the *ijma‘*. The Arabic word *ijma‘* means a consensus of opinion of the *mujtahids* (i.e., the Islamic jurists or those who exercise independent legal reasoning), of a particular age on a question of law. The fourth and last source of *shari‘ah* is the *qiyas* or *ijithad*, which is the process of reasoning by analogy of the *mujtahids* with regard to certain difficult and doubtful questions of doctrine or practice, by comparing them with similar cases already settled by the authority of *al-Qur‘an* and *sunnah* and thus arriving at the solution of undecided questions.

1. *Al-Qur‘an*

*Al-Qur‘an*, which literally means ‘reading’ or ‘recitation’, is the first and most important source of law for Muslims. All that was revealed to the Prophet Muhammad (pbuh) through the angel Gabriel and subsequently presented in *al-Qur‘an*, is the direct word of God. It constitutes a complete and unique text, the exact letter of which is God’s design

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52 Al-Qur‘an, 53:3-4.
and will. As such, it specifies the moral, philosophical, social, political and economic basis on which an Islamic society should be constructed.

*Al-Qur’an* is believed to be unique and inimitable. It is the first foundation of Islam and is primarily a book of religious and moral principles. It is divided into 114 *suras* or chapters and contains 86430 words and 323760 letters of the Alphabet. The total number of verses is 6666. These revelations were spread over 23 years of the Prophet’s life according to the needs of time and to provide solutions to the problems, which came before him. The verses in *Al-Qur’an* cover three broad areas: the “science of speculative theology”, “ethical principles” and “rules of human conduct”. Islamic jurisprudence is directly concerned with the third category of verses, revealed in Madinah and destined to transform the behaviour of individuals and thus reform society according to divine injunctions.\(^{53}\)

The arrangement of chapters in *al-Qura’n* has created much interest among Muslim and non-Muslim scholars alike. Generally the long chapters are placed in the beginning and the short chapters are at the end. Basically they are divided according to the place of its revelation. Chapters revealed in Makkah are called Makkah chapters and those revealed in Madinah are called Madinah’s chapters. A total of 92 chapters were revealed in Makkah and the remainders were revealed during the Madinah period. The Makkah revelations mainly deal with faith in God and are particularly devoted to grounding Muslims in that faith, while the Madinah revelations are mainly intended to translate that faith into action. However, there is a clear testimony, internal and external as well, that every single verse or part of it and every chapter that was revealed had its own definite place in *al-Qur’an*. As God says in chapter 25, verse 32:

"Those who reject say: "Why is not the Qur’an revealed to him all at once?" Thus (is it revealed), that We may strengthen your heart. Thereby, and We have rehearsed it to you in slow, well-arranged stages, gradually."

The important principle to be borne in mind in the interpretation of al-Qur’an according to some scholars is that the meaning should be sought from within al-Qur’an, and never should a passage be interpreted in such a manner that it may be at variance with any other passage, but more especially with the basic principles laid down in the decisive verses.\textsuperscript{54} Another great scholar Shah Abdul Aziz Dehlavi believes that those who seek to interpret al-Qur’an should keep in mind the following three conditions:

a) Every word should be explained with its real meaning so that it shows the reality of its objective. In order to achieve this, the scholar has to employ linguistic knowledge and grammar.

b) Everything should be explained with reference to the context of the main theme of the revelation.

c) The interpretation should not be contrary to the writings of the sahabah or the companions of the Prophet, who witnessed the coming of the revelations to the Messenger of Allah.\textsuperscript{55}

2. Hadith

Hadith constitutes the second authoritative source of shari‘ah after al-Qur’an, which is God’s word and first source of shari‘ah. Hadith is the interpretation and explanation of al-Qur’an.\textsuperscript{56} It has come to supplement the same as a source of the Islamic religious law.

\textsuperscript{54} Ali, Muhammad, \textit{The Religion of Islam, A Comprehensive Discussion of the Sources, Principles and Practices of Islam}, Lahore, 1950, p.34.


\textsuperscript{56} Al-Qur’an, 16:44.
Prophet Muhammad (pbuh), as *al-Qur’an* clearly states, never spoke from his own imagination but told only what God had revealed to him. It says:

“Nor does he (the Prophet) say (ought) of his own desire. It is no less than inspiration sent down to him”.\(^{57}\)

In another statement, *Al-Qur’an* also states:

“Whatever the Messenger brought to you take hold of it, and whatever he forbids you of, abstain from it”.\(^{58}\)

In reality, the whole life of Prophet Muhammad (pbuh), whatever he did or said, was according to the guidelines of *al-Qur’an* and hence, every single event of his life and teachings if taken together becomes a complete exegesis of *al-Qur’an* put into practice by himself. Therefore, the *hadiith* or traditions of the Prophet are important in the development of Islamic Legal System and Jurisprudence and hence, Muslims can always turn into this source of *shari’ah*, be they legal or religious.

*Hadiith* has root meanings of ‘being new’ and ‘occurring’, ‘taking place’, ‘coming to pass’ and extends to ‘talking about’ or ‘reporting what has happened’.\(^{59}\) Therefore, *hadiith* is a report or a verbal tradition, transmitted from person to person and from generation to generation by word of mouth, of what Prophet Muhammad (pbuh) said or did, or his reaction to something said or done by others. In *shari’ah*, *hadiith* describes the *sunnah* which refers to those practices of the Prophet which are part of his prophetic mission, not mere incidentals, and which were followed by his companions. Thus, the order in which Muslims pray are examples of *sunnah*, while to live in Madinah or to ride a

\(^{57}\) Al-Qur’an, 53:4.

\(^{58}\) Al-Qur’an, 59:7.

camel are not. The Prophet used to make a clear distinction between those of his actions, which were not.

The materials of the hadith were collected by Islamic jurists at the end of the eighth and the beginning of the ninth century. Six of these collections have gained such general approval that later generations of jurisprudents tacitly accept them as the Six Canonical Collections. These materials cover, among other things, a large amount of economic matters from the earlier period of Islam, concerning for example, private property and inheritance, public finance, financial transactions, and commercial ethics. Contemporary Muslim jurisprudents frequently use these sources to solve practical economic problems. In many cases hadith confirmed, extended, explained, elaborated and complemented the revelation. The Prophet is obviously considered the best interpreter of the Divine messages, providing practical explanations of al-Qur’an. For example, without giving the details of payment and calculation, al-Qur’an repeatedly commands the believers to pay zakah or wealth taxes, the rules and regulations of which were given by the Prophet.

As far as the shari’ah is concerned, not all hadiths can be used as a source in formulating the law. Hadith in the category of sahih or sound are the primary source of shari’ah law. Hadith in the category of hasan or fair are not considered quite strong enough, but they are necessary for establishing points of law. Indeed, most of the hadiths concerning legal matters are of this type. Hadith which falls into the category of da’if or weak and deals with matters of law, or with things which are allowable or forbidden will be rejected. Allowance is made, however, if the hadith deals with exhortations, stories, and

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60 These collections are: Sahih al-Bukhari (dead A.H. 256/C.E. 870), Sahih Muslim (d. 261/875), Sunan Ibn Majah (d. 273/887), Sunan Abu Dawud (d. 279/888), Jami’ al-Tirmidhi (d. 279/915), and Sunan al-Nasai (d.303/915).

good behaviour. Muslim scholars have developed the following principles for rejection of the hadith:

a) If it was opposed to recognised historical facts.

b) If it was of the nature of an accusation against the companions of the Prophet (pbuh) or a member of his family. If, however, such a report was corroborated by independent testimony, it was accepted.

c) If it was of such a nature that to know it and act upon it was incumbent upon all, and it was reported by a single person.

d) If the time and the circumstances of its narration contained evidence of its forgery.

e) If it was against reason or against the plain teachings of Islam.

f) If it mentioned an incident, which, had it happened, would have been known to and reported by large numbers, while as a matter of fact that incident was not reported by anyone except the particular reporter.

g) If its subject matter or words were unsound or incorrect; for instance, the words were not in accordance with Arabic idiom, or the subject matter was unbecoming to the Prophet’s dignity.

h) If it contained threats of heavy punishment for ordinary sins or promises of mighty reward for slight good deeds.

i) If it spoke of the reward of prophets and messengers to the doer of good.

j) If the narrators confessed that they fabricated the report.
3. *Ijma*  

Apart from *al-Qur’an* and the *hadith*, the two primary sources of *shari‘ah*, there are two secondary sources. One of them is *ijma*, the consensus of juristic opinions of the qualified legal scholars on various Islamic issues after the death of Prophet Muhammad (pbuh). If one cannot find either a relevant text from *al-Qur’an* or a relevant *hadith* then one turns to a third source based on *al-Qur’an* and the *hadith*, namely the general agreement of Islamic scholars of a particular age regarding a ruling appropriate and applicable to the situation in hand. The ruling thus unanimously decided upon became fixed and definite and part of the permanent body of *shari‘ah*. 62

*Ijma* owes its origin to verses 59 and 115 of chapter 4 of *al-Qur’an*. 63 The emergence of this concept as a source of law is also in line with the *hadith*, which observes: ‘My nation will not agree unanimously in error’. This term also denotes the universal acceptance by all Muslims of the fundamental tenets of the faith, such as belief in the mission of the prophet and the Divine nature of *al-Qura’n*. If the community were of one mind on a particular matter in an area on which their unanimous view was not inconsistent with that of *al-Qur’an* or *hadith*, it was accepted as valid. The limitation upon the authority of *ijma* that it must not be in conflict with *al-Qur’an* or *hadith*, is obviously a significant one.

*Ijma* was regarded as absolutely authoritative not only for discerning the right at present and in the future, but also in establishing the past: it was *ijma* that determined

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63 The verse 115 says: “O believers, obey God and obey the Messenger and those in authority among you. If you should quarrel on anything, refer it to God and the Messenger”. While the verse 59 states: “Whosoever makes a breach with the Messenger after the guidance has become clear to him, and follows a way other than that becoming to men of faith, We shall leave him over to what he has chosen and We shall land him in the fire of hell – an evil refuge.”
what the *sunnah* of the Prophet had been and indeed what the right interpretation of *al-
Qur’an* was. This *ijma‘* or agreement of the Muslim community is to arrive at by *ijtihad* or
exertion, or conscientious examination and mediation on the subject under consideration.
There is also so-called ‘composed agreement’ or unanimous agreement as to the matter,
differences as to the cause; and simple agreement, which denote absolute agreement in
everything. In general, two kinds of *ijma‘* may be distinguished. The first kind refers to
an agreement on the interpretation of a certain Quranic verse or text of *hadith*. The second
kind of *ijma‘* is a universal practice or statement on a specific matter. However, there are
some examples of consensus, such as the law of pious foundation (*waqf*), which do not
rely explicitly on *al-Qur’an* or *hadith*.

The *ijma‘* is of more relative importance for the purpose of this study, because the
theory for the models of Islamic banking are not mentioned in either *al-Qur’an* or in
*hadith*. The establishment of modern Islamic banking has been based on, among other
things, the consensus of modern Muslim scholars and jurisprudents at both national and
international levels.

4. *Qiyas* or *Ijtihad*

The fourth source of *shari‘ah* is the *qiyas* or *ijtihad*. The word *qiyas* etymologically means
measurement or comparison, while *ijtihad* means effort or an exercise aimed at arriving at
one’s own judgment. But literally, *qiyas* can be defined as analogy, or analogical
deduction, and *ijtihad* as deduction by independent reasoning. In other words, *qiyas* is the
legal principle introduced in order to derive at a logical conclusion of a certain law on a

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64 Haron, Sudin, *Islamic Banking: Rules and Regulations*, op. cit., p.49.
certain issue that has to do with the welfare of the Muslims. In exercising this, however, it must be based on al-Qur’an, the sunnah and the ijma’.65

Qiyas plays a vital role in Islam and al-Qur’an clearly recognised this process. Al-Qur’an says in chapter 2, verse 59:

“Think deeply, O you who are understanding.”

The people of understanding referred to in this verse must use their common sense to deduce Islamic law. The Prophet himself is reported to have sanctioned and encouraged reasoning and the exerting of the faculties of one’s mind, in order to find the proper solution of difficult and doubtful cases of law. The prophet, as reported by Abu Dawud in his Sunan, had accepted the answer given by Mu‘adh Ibn Jabal whom he sent to Yemen as Judge and Governor that he would exercise his own judgment and act on that if he found no direction in al-Qur’an, and the sunnah.66 An example for the qiyas is that the wine is prohibited by al-Qura’n, and the reason (‘illah) for this prohibition is the intoxication. Therefore, though not mentioned in al-Qur’an and hadith, other intoxicants are prohibited by qiyas, because of their intoxication.

The sources described above took their shape during the formative period of Islam, which stretched from the time of Prophet Muhammad (pбуh) until the middle ages. In this sense, they were best suited for the time in which they were created. For various reasons, these sources have a limited relevance in solving practical problems, particularly in contemporary times. In order to overcome this problem, many legal reforms and innovations have been carried out in many fields, introduction of which is justified by the notion that ‘necessity permits the forbidden’ (al-durarah tubih al-mahzurai), which is

65 Doi, Abdur Rahman, I., Shari‘ah: The Islamic Law, op. cit., p.70.
66 Ibid., p.71.
tacitly accepted by all legal schools. An example of this doctrine is that drinking wine is permitted where human life is in danger. Many new legal innovations have been produced as a result of cooperation among many jurisprudents belonging to different schools of law. These innovations cross the borderline between the various legal doctrines.

3.3 Islamic Economy: Its Characteristic Features

Islam as a religion views life as a compact whole and as such does not compartmentalise various aspects of human life. The economic aspect is one of the most important parts of human life, while not being the whole of it. In Islam everything is for the benefit and welfare of mankind. Indeed, the legal texts of *al-Qur'an*, which explicitly discuss economic issues, are estimated to be 20 out of 500 verses. The main verses dealing with economic issues are concerned with the subject of taxation and *riba*. However, many verses in *al-Qura'n* have been used in the process of deduction by analogy as a basis economic rules. The underlying principles of Islamic economy aim at establishing a just society wherein everyone will behave responsibly and honestly, and not fighting for getting as big a share of something without regard to honesty, trust and responsibility. Islam has laid down many rules and regulations about economic life of mankind. It is the responsibility of the *khilafah* - the Islamic political process to bring all productive resources into use, and take steps to root out corruption and all harmful pursuits in the society.

The economy as introduced by Islam is fundamentally different from the predominantly secularist economic systems of the present-day world. Like other economic

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systems, Islamic economics is not value-neutral. It has certain value premises from which it begins and from which it operates. Islamic economics makes it very clear that economics is not to be studied in isolation from other aspects of social life. Economic phenomena and economic behaviour are to be studied in the context of the totality of human life. Islamic economics deals not only with how human beings behave, but also how they should behave. It also deals with motives as well as behaviour institutions and policies. This approach is a distinctive feature of Islamic economics. Islam provides humanity first a set of objectives and values in economic life; second, a psychological attitude; third, a spectrum of motives and incentives; fourth, a social-political infrastructure for economic institutions, and finally, principles of economic relationship. Economics being a subsection of the ideological and ethical system of Islam has its distinct existence, but it is only as a sub-section of the total system.

The primary value for Islamic economics as for the entire Islamic faith and religion is tawhid or unity of thought. Islam does not look upon God as not relevant to the human situation. In Islam, God is the Creator, the Lord, the Sovereign, the Sustainer, the Nourisher. God’s intervention is a reality, and thus according to Islam, human being has a close and direct relationship with the law, with the Creator.

The second basic value that Islamic economics deals with is the vicegerency of humanity. Human beings are not just the products of an accident. They have been given a definite position and that position is that of God’s deputy. It means that human beings must worship; they have their freedom, their faculties or intellect, accountability, relations and moral existence. It also means that they are here with a responsible mission to serve, to change, to re-create, to rebuild, to reconstruct. All problems of life - social, political,
economic, cultural and so on are elements of this new moral ideological approach. It also means that human beings are not the masters. They are only trustees. They have been entrusted with whatever they have and whatever is there in the universe. They have to operate these available sources without extravagance and waste as trustees. Trusteeship brings the idea of accountability in this world before humans, and before God in the life after death in order that the Islamic society cooperates and deals with the rest of the world as an entity.

The third important value, which is the objective for all human effort, is `adl or justice. This is the objective to which social justice, political justice and justice between human beings is to be directed. The Islamic economic approach is one which is directed towards the achievement and actualisation of justice in human relations. The result of this effort is (falih)\(^{69}\) or success and salvation, and (hayah tayyibah)\(^{70}\) or good life in this world and in the hereafter.

With these economic objectives in mind, which have to be kept in mind for all economic policy-making and economic thinking also, and which are in precisely, first, human dignity, freedom and brotherhood; second, efforts to make the best possible use of human resources and material resources, that is, to make productive effort for achievement of optimal growth; third, achievement of social and economic justice for elimination of poverty, reduction of inequalities and human relations building, Islamic economics starts with a set of values known as halal or what is permitted, and haram or what is forbidden. And within these two extremes there is a vast area of permissibility, which is to be experimented with. Furthermore, the approach of Islamic economy is human centered,

\(^{69}\) The terminology of falih is used in the Qur'an total forty times in different conjugational forms.

\(^{70}\) The expression of hayah tayyibah stems from the verse 97 in chapter 16 of Al-Qur'an.
whereas the western economics is wealth centered. Wealth is definitely one of the concerns of Islamic economics as it is needed for well-being, but the core of the study of Islam is human being. As against the economic rationality of capitalism and communism, Islamic economic rationality consists of decision-making with a view to achieving *falah* or human well being and *`adl* or justice for oneself and for other human beings. Islam does not deny one’s own interest, but incorporates it into its ethics and supplements it by the interests of other members of society. Again, the interests of the individual and of society have not been looked upon by Islam as antipathetic as they have been by other traditions. For example, capitalism went towards the extreme of individualism, while socialism and communism went towards collectivism to the neglect of the individual. In Islam, the interests of the two are harmonised, and this harmonization of the individual with society has taken place through the set of regulations, values and laws.

### 3.4 Distributive Justice: An Islamic Perspective

Distributive Justice has always been extremely important in all human societies and a lot of conflicts have taken place throughout history because of distributive justice. At one extreme, some economists view that, “our primary problem is production. The common man or average family has a far greater stake in the size of our aggregate income than any possible distribution of income.”⁷¹ At the other extreme, some others assert that, “to determine the laws which regulate distribution, is the principal problem in Political Economy.”⁷² But the approach of Islamic economics towards this issue is quite different.

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Islam being a religion sent by God as a mercy and guidance to people as mentioned in al-
Qur’an,\(^7\) and as its followers believe, provides certain goals and means to deal with this
controversial issue of distributive justice. Islamic economics having been essentially value
based is not shy of making value judgments.

The very word ‘distributive justice’ is a combination of two distinct words:
distribution and justice. The discussion of distribution is closely related to the rights of
individuals in a society. It is these rights, in person and property that provide the ground
rules for economic behaviour, which, in turn, determines the distribution of income and
wealth among individuals. The Islamic concept of ownership rights is fundamental to the
determination and achievement of the desired pattern of distribution. Therefore, it is
necessary to highlight the Islamic concept of ownership before going into the core topic
from an Islamic viewpoint on distributive justice.

### 3.4.1 Concept of Ownership in Islam

If we look into the two major sources of Islamic Law, the shari’ah - al-Qur’an and the
hadith - we can draw a conclusion of the elements of Islamic Ownership as follows:

1. *Al-Qur’an*, the basis of all Islamic regulations, categorically states that the
absolute ownership of every thing belongs to God alone.\(^7\) God as the Sustainer and the
Creator of human being has got absolute right to bestow them with property on God’s own
choice, and to restrict its disposal and utilisation by them.

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\(^7\) Al-Qur’an, 6:157, 7:52, 203, 10:57, 16:64, 89, 31:3, 45:20.
God’s absolute ownership of everything means that what God has created belongs collectively to the whole society. God empowered individuals to possess, enjoy and transfer what God has bestowed upon them. Thus, the nature of ownership in Islam is that of trusteeship and subject to the terms of that trust. For human beings are given authority to take benefit of all things as God’s trustees on earth. They should cooperate with each other as every one of them belongs to God’s family. In Islam, bond of individual’s relationship with group and vice versa is based on strong brotherhood.\textsuperscript{75} Thus, ownership in Islam has religious connotations and is used quite loosely. Frequently ownership is used interchangeably to mean enjoyment of property.

The right of the individuals’ private ownership is established by their efforts and earnings. The Qur’anic verses categorically affirm that individuals have their own entity and they are solely responsible for their every single deeds.\textsuperscript{76} This Qur’anic concept has got some effects and prerequisites in Islamic law in general, and in the field of economics in particular, where the individuals irrespective of their position, can enjoy their right on property alone without any objection or restriction.\textsuperscript{77}

Besides, there are some rules set out by Islamic shari‘ah in regard to the conduct of the owner of private property. They are:

a) The non-use of property is not allowed in Islam. Because, it is wasteful and impoverishes the owner as well as the community as a whole. In this situation the State has the right to intervene and deprive them of ownership to the extent of land remaining unutilised. The general rule is that property should be used at all times and in a rightful way for the benefit of the individual and of the community as

\textsuperscript{75} Iqbal, Munawar, (ed.), \textit{Distributive Justice and Need Fulfilment in an Islamic Economy}, Leicester, 1988, p.12.
\textsuperscript{76} Al-Qur’an, 74:38, 2:286, 19:80.
well. According to the Qur’anic injunction wealth must remain in constant circulation among all sections of the community and should not become the monopoly of the rich.\textsuperscript{78}

b) The owners of the property must pay zakah\textsuperscript{79} in proportion to the property they own, to the poor and needy - who do not have enough wealth to satisfy basic needs and who are unable to work, as well as to the benefit of the Muslims as a whole.

c) The utilisation of property must in all causes benefit the community as a whole and be conducive to its prosperity and welfare. It is always relative to the needs of the community and values of life, and changes with changing circumstances. The beneficial use of wealth and resources is one of the basic conditions by which the Muslim community can prosper.

d) The owners of the property are not permitted to use their property in such a way as to cause harm to others or to the community. Since absolute ownership of everything belongs to God and every individual - rich or poor - has the inherent right to use it, once harm is done to others, this would be aggression, which is forbidden. The State should take active steps to prevent undue concentration of property in the hands of a few persons by legislation.\textsuperscript{80}

e) All unlawful means of acquiring property are prohibited as those in the end destroy a people; such as acquisition of wealth through falsehood, cheating, etc. In that case the state enjoys full power to take actions against dishonest activities. Islam views that wealth hoarded or monopolised would be punished because it deprives the owner and the rest of the community as well of its beneficent use.\textsuperscript{81}

\textsuperscript{78} Al-Qur’an, 59:7.
\textsuperscript{79} For a detailed discussion on zakah see, 3.4.4.
\textsuperscript{80} Mannan, M.A., Islamic Economics: Theory and Practice, op.cit., p.91.
\textsuperscript{81} Al-Qur’an, 9:34.
f) The owners of the property must use the property in a balanced way. In other words, they should be neither extravagant nor niggard in its use. As regards extravagance, it can be said that wealth lawfully acquired is a bounty of God, which is bestowed upon by God as a means of support. It should be looked after in proper manner and not be wasted. As regards niggardliness, on the other hand, it must be admitted that some people have a tendency of holding their property back, not realising that it renders a person progressively poorer, and, by putting that which they possess out of service, renders it completely unfruitful.

g) The use of property should be for the purpose of securing the owners’ due benefits. It is observed that in practice many people utilise their property for securing for themselves undue special benefits in political and economic spheres to the neglect of the larger interests of the community. In Islam, the state must ensure that property is never used for the attainment of such selfish objectives.

h) The last rule set out by shari’ah in regard to the conduct of the owners of private property is the rightful application of the Islamic law of inheritance for the sake of the interests of the living. Since the question of control and distribution of wealth after death of the owners does not arise, the due interests of its heirs must have secured through implementing Islamic laws of inheritance.

Keeping in view of all these rules it may be mentioned that the uniqueness of the Islamic concept of ownership lies in the ethical and moral injunctions attached to it. The religion of Islam contains principles, which, if understood and applied in a right manner, might be the best possible solution to the evils of all man-made theories and ideologies and ensure happiness, order and justice.82

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3.4.2 Islamic Objectives of Distribution

Distribution though can be viewed from a number of angles – personal, functional, temporal, regional, etc. the main concern of the present discussion is with the functional and the personal distributions. The functional distribution is meant a distribution of income according to the productive agent who receives the income. In the personal distribution, one is looking how income is distributed among individuals in a society, regardless of how any individual receives his or her share of income. Besides, in discussing personal income, one is referring directly to the welfare of individuals. The Islamic approach to distributional equity almost exclusively centers around the personal distribution of income. Before we go to the core topic i.e., Islamic viewpoints towards distribution we would like to discuss shortly here some prominent schools of thought in political philosophy of redistributing income.

According to philosophers J. Bentham (1748-1832) and J. S. Mill (1806-1873) the founders of utilitarianism, utility is a measure of well being as well as the ultimate objective of all public and private actions. The proper goal of the government, they claim, is to maximise the sum of utility of everyone in the society. According to the Utilitarian school of thought, redistribution of income should be based on the assumption of ‘diminishing marginal utility’. It seems reasonable that an extra dollar of income to a poor person provides that person with more additional utility than does an extra dollar to a rich person. This plausible assumption, together with utilitarian goal of maximising total

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84 The political philosophy according to which the government should choose policies to maximise the total utility of everyone in society.

utility, implies that the government should try to achieve a more equitable distribution of income. This thought has been criticised arguing that this might seem to imply that the government should continue to redistribute income everyone in society has exactly the same income. But, in fact, it is not.

A second way of thinking about redistribution of income is called the ‘maximin criterion’, which has been developed by philosopher J. Rawls in his book *A Theory of Justice* (1971). Rawls begins with the premise that a society’s institutions, laws and policies should be just. Since every person’s point of view in society is inevitably based on his or her particular circumstances and one can never objectively determine what a just society would be, he proposes to choose a just set of rules based on fair agreement or bargain in order to consider how those rules will effect every person. Rawls then considers, in particular, what income distribution a person would consider just if that person did not know whether he or she would end up at the top, bottom or middle of the distribution. He argues that a person in the original position would be especially concerned about the possibility of being at the bottom of the income distribution. In designing public policies, therefore, one should aim to raise the welfare of the worst-off person in society. That is, rather than maximising the sum of everyone’s utility, as a utilitarian would do, Rawls would maximise the minimum utility.\textsuperscript{86} This thought, however, has been criticised by the opponents saying that it would not lead to a completely egalitarian society. Because, if the government promised to equalise incomes completely, people would have no incentive to work hard, societies total income would fall substantially, and the least fortunate person would be worse off.

\textsuperscript{86} Ibid., pp.440-441.
A third view of redistributing income is called libertarianism. Unlike utilitarians and supporters of Rawls, libertarians argue that society itself earns no income – only individual members of society earn income, and as such, the government should not take from some individuals and give to others in order to achieve any particular distribution of income. For instance, philosopher R. Nozick says in his famous book *Anarchy, State and Utopia*: “There is no central distribution, no person or group entitled to control all the resources, jointly deciding how they are to be doled out. What each person gets, he gets from others who give to him in exchange for something, or as a gift” \(^{87}\).

The libertarian alternative to evaluating economic outcomes is to evaluate the process by which these outcomes arise. When the distribution of income is achieved unfairly the government, as they believe, should interfere to solve the problem. But, as long as the process determining the distribution of income is just, the resulting distribution is fair, no matter how unequal, and the government has no reason to alter the resulting distribution of income. According to them, equality of opportunities is more important than equality of incomes, and as such, the government should enforce individual rights to ensure that everyone has the same opportunity to use his or her talents and achieve success.

Among the ways of thinking about inequality and redistribution of income discussed above, Rawls's 'maximin criterion' seems to be nearer to the Islamic approach to redistributing income. Islam allows freedom of enterprise and accommodates interpersonal economic differences as a part of the Divine Scheme.\(^{88}\) At the same time it emphasises, in very strong and unmistakable terms, the need for distributional equity.

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\(^{87}\) Ibid., pp.441-442.

Islam believes in striking at the roots of inequality rather than merely alleviating some of the symptoms. It has incorporated into the faith itself a number of measures which would not allow an unjust distribution to take place. Above all, Islam aims at preventing the emergence of malady rather than treating it after its emergence. It has a built-in program to reduce the remaining inequalities even further through zakah, and numerous other methods to bring about a distribution of income which is humane and in conformity with its concept of human brotherhood.\textsuperscript{89}

The major objectives of Islam in distribution may be described as follows:

1. Guarantee of fulfillment of basic needs for all;
2. Equity but not equality in personal incomes; and
3. Elimination of extreme inequalities in personal income and wealth.

The guarantee of fulfillment of basic needs of all people in society is a fundamental Islamic objective of distribution and redistribution.\textsuperscript{90} The fulfillment of the basic needs of all humans is an essential component of the Islamic vision and a primary objective of organised Islamic living. It is supported by overwhelming rules explicitly stated in the texts in \textit{al-Qur`an}\textsuperscript{91} and the sunnah. There is total agreement among Islamic jurists and economists that this is the most important objective of the Islamic distributive scheme. But what are these basic needs the fulfillment of which Islam recognizes to be an obligation of Islamic society? How is this guarantee to be fulfilled? Muslim scholars provided a long list of needs giving precedents from the early history of the Islamic state to support their view,

\textsuperscript{90} The allocation of income that takes place through mutually agreed transactions among individuals in the market is referred to as distribution while when society uses extra market or other non-market processes to modify that particular distribution is called redistribution.
\textsuperscript{91} There are 60 verses that stipulate, mandate, encourage charity; discuss its virtues and rewards; warn of punishment to those who eschew charity and also warn against hoarding. See for example, 9:34, 2:261, 2:265, 2:276, 2:280, 30:39, 34:39, 35:29, 57:11, 57:18, 64:17, 2:271, 2:245, 5:12, 57:11, 57:18, 64:17.
which include food, clothing, shelter, medical care and education. Depending on social circumstances and the availability of financial resources other needs may also be included. They suggested that the resources for funding need fulfillment programmes may come out of zakah revenue, other state revenue and taxes levied especially for this purpose. These scholars provided very strong theoretical basis for the fulfillment of basic needs. They pointed out that it does not mean that a basket full of life’s necessities would be doled out to every individual in all circumstances. Individuals are normally expected to fulfill their needs through their own efforts. If owing to some reason, that is not possible, then the responsibility rests with one’s near relatives, neighbourhood and society in general. The state may not have to resort to heavy taxation.

Having ensured the fulfillment of basic needs of all, Islam permits interpersonal differences in income. This drives from the Islamic view of justice to every one. Since naturally human talent and ability are not same and contribute different amounts to the production process, it would be unjust and inefficient to equate all people in terms of their earnings. It might damage individual incentive and productive efficiency. Furthermore, it would lead to inactivity or to compulsion and both of which are disliked by Islam.

Distributive justice in Islam does not mean perfect equalities of income; the question may arise, i.e., what is the most favourable level of inequality? In order to establish justice and uphold mutual love and brotherhood, Islam discourages extreme inequalities between one person to another. For the same purpose it does not recommend a ratio between the minimum and the maximum income. Thus, all inequalities that can create abhorrence, meanness and ill feeling among individuals should be abolished.

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92 Iqbal, Munawar (ed.), Distributive Justice and Need Fulfilment in an Islamic Economy, op.cit., p.81.

In the Islamic system, in the first place, by eradicating all kinds of exploitative practices, the possibility of excessive inequalities is reduced to a minimum level. Then, to reduce inequalities and encourage social solidarity, Islam advises a person not to be discontent against someone who has more than others. On the other hand, it stipulates a number of measures to redistribute wealth among the poor through minimising the negative effect on individual incentives. The giver obtains positive utility and takes pleasure in rather than shows antipathy towards sharing his income and wealth with others.

3.4.3 The Islamic Strategy for Distribution

The most important features of the Islamic strategy for the realisation of the desired pattern of distribution may be described as follows:

a) Islam favours an ‘institutional approach’ in its distributive scheme. These institutions include *awqaf* or endowments i.e., property voluntarily and permanently transferred to a charity or trust so that its usufruct may accrue to other people; *takaful* or scheme of mutual support which provides insurance to individuals against hazards of falling into unexpected and dire need; *manihah* or donation of usufruct i.e., a productive asset granted to a needy person for a specific period to freely utilise it and enjoy its usufruct; inheritance and the elimination of *riba* or interest, etc.

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94 See, for example, a *hadith* related by both Bukhari and Muslim on the authority of Abu Hurairah – which says, “Look at the person who is inferior to you, and do not look at one who is superior to you, so that you would not become ungrateful to Allah for the favour He bestowed upon you”. (Bukhari, Abu ‘Abdullah Muhammad Ibn Isma’i, *Sahih al-Bukhari*, 11/276; also Muslim, Ibn al-Hajjaj Ibn Muslim al-Qushairi, *al-Jami’ al-Sahih*, 2963.)
b) Islam prefers a decentralised structure of redistributive scheme. It requires one to look after the needs of his or her near relatives, neighbours, locality and then society at large. From an economic point of view, this minimises the disincentive effects on both the donor and the recipient. When a person spends his or her money on near relatives and neighbours and observes its effects to reduce their grief, he or she does not feel the disincentive effects that a person feels when he or she is subjected to high rate of progressive tax on his or her income even though that money is spent somewhere to relieve similar miseries. Similarly, the recipient cannot become a dependant or living on public funds because in a localized arrangement his or her real circumstances and attitudes are known to the donors who can create social pressure to get him or her involved in work and provide the necessary means for him or her to do so.

c) Islam uses a multiplicity of redistributive measures. Each one of them, taken alone, may appear to be small but their combined effect implies a substantial transfer. This again has a number of economic advantages. On the one hand, it broadens the base on which transfer applies and, on the other hand, it reaches every category of deserving recipient. Again the minimal incidence of each one of them reduces the negative effects. Many of them do not involve any cost to the donor but increase the marginal utility of the recipient substantially.

d) Islam uses a hierarchy of compulsory and voluntary, permanent and temporary measures, which lend flexibility to the system. Shari'ah has declared some of the schemes, such as zakah, participation in the ownership of some natural resources and the system of inheritance, as permanent and compulsory. There are additional measures, which are brought into use if and when necessary. The permanent
measures normally ensure that the distribution does not deviate too much from the
desired pattern, while temporary measures are there to take care of exceptional
circumstances.

e) Redistributive measures are important in the Islamic strategy for achieving the
desirable pattern of distribution, on the one hand. Other measures such as
prohibition of *riba*, the promotion of profit sharing, discouraging monopolies,
correcting ownership partners, the equality of opportunities, the emphasis on
employment and work, just wages, the prohibition of certain trade practices, etc.
have direct implications for the distribution of income, and are no less important in
realising the Islamic distributive ideals than redistributive measures.\(^{95}\)

f) The Islamic approach is much broader than the approach of conventional
economics. It does not restrict itself to the elimination of poverty as commonly
understood. It attempts to relieve all kinds of hardships. For example, it tries to
provide help to travelers in distress even if they are otherwise rich, to debtors even
if they have some property but the property is needed by them to earn their living,
to farmers i.e., producers whose produce has been destroyed due to some natural
calamity, to persons who incur financial liabilities as a result of some accident, and
so on.\(^{96}\)

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\(^{95}\) For an elaboration, see Zarqa, M. Anas, “Islamic Distribution Schemes”, in Iqbal, Munawar (ed.),

\(^{96}\) Zarqa, M. Anas, “Distributive Justice in Islam”, in Ahmad, Ausaf and Kazim Raza Awan (eds.) *Lectures
3.4.4 *Zakah and Distributive Justice*

*Zakah* is one of the five pillars of Islam and is a way of expressing one’s appreciation to God for seeking God’s blessings, which reflects in the growth of wealth and the real well-being of all.\(^97\) Technically, *zakah* implies the financial obligation of Muslims to pay a specified portion from their cash property, trade merchandise, grains and herds of cattle as an indispensable part of their religious duties if these are equaled or become higher than the *nisab*.\(^98\)

The emphasis placed on *zakah* is clear from the fact that *al-Qur’an* mentions *zakah* in 29 verses out of which 25 have been mentioned in association with *salah* i.e., regular prayers. After the declaration of faith these two pillars are considered to be the most important fundamentals of Islam. The repeated mention of *zakah* indicates that worship of God is not complete if not accompanied by paying *zakah* to the poor and needy.

Although the *Qur’an* did not specifically identify the zakatable items of wealth, it sometimes made classified references to certain wealth such as gold, silver, fruits, agricultural products, mineral resources etc. which apparently are the subject of *zakah*.\(^99\) Besides, some oblique references of *al-Qur’an* also suggest that *zakah* is to be applied on all types of *amwal* or wealth.\(^100\) However, although *al-Qur’an* refers to applying *zakah* on wealth in general, it is the Prophetic *sunnah* that came with the bound of *nisab* beyond which it may not be applied. It should be remembered that at the time the Prophet gave the rules for *zakah*, the possessions Muslims had were gold and silver as currency and/or in

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\(^98\) Threshold of wealth owned by an individual, a level or excess over which is subject to pay *zakah*. So, anyone above the *nisab* is a *zakah*-payer, while one below it is a *zakah*-recipient. The *nisab* is set to allow an individual an acceptable standard of living.


\(^100\) See, for example, 9:103; also 51:19.
stocks, merchandise of trade, flocks of animals and the annual firm produce. The Prophet levied zakah on all of these items. But it is evident in the traditions that the Prophet exempted from zakah taxation articles considered necessities of life, and the means of production and transportation.\footnote{See Sahih al-Bukhari, 2:271-338, Sahih Muslim, 2:466-521.}

Al-Qur’an did not also give the rates of zakah, nor the types of level of income or wealth on which it is to be paid, except mentioning the payment of dues on agricultural produces in general terms.\footnote{Al-Qur’an, 6:141.} The details of all these were given by the Prophet. Later, the Rightly Guided Caliphs added numerous other categories of wealth and produce to zakah tax-base using the principle of qiyas or analogy. However, the zakah rates were not changed as part of the moral-legal binding of Prophetic sunnah. Since then, a general consensus (i.e., ijma’) has held that the rates should be taken as fixed. According to the rules explained in the sunnah, the ratio of zakah is fixed at 2.5 per cent of total net worth of most physical and financial assets including gold, silver, stocks, merchandise of trade etc. But in agricultural produces, the ratio is determined by the means and expenses involved in production. It is described that the applicable rate of zakah on the agricultural produce from artificially irrigated land is ‘ushr or one tenth, and on the naturally irrigated land is half of ‘ushr or one twentieth.\footnote{See Sahih al-Bukhari, 2:327.}

The Prophet gave the lower limits of Zakatable assets according to the then commonly held assets or properties. He specified that when any one’s net worth equaled or exceeded the following nisab, zakah would be levied on the total value of incomes or assets: five uqiyahs of silver (i.e., 796 grams or 26 troy ounces) or 200 dirhams in currency, both equal in value at that time; five wasqs of grains e.g. wheat, rice, corn,
barley, dates, dates etc. (i.e., 1600 liters or 45.4 bushels), 40 sheep and five camels, all approximately equal in value to 200 Dirhams according to the price estimates available.104 Given the perspective, what becomes evident is that there was a value equivalence of 200 Dirhams among the different nisab fixed by the Prophet whether specified by volume, value, currency produce or cattle. The nisab of 200 Dirhams or its equivalent represented such levels of income or assets, which could enable a person to meet his or her essential food and clothing requirements and leave some funds for other expenses at that time. As this nisab value will differ from country to country and change over time with changes in prices of basic need items it will always represent zakatability of assets when they exceed the basic need requirement of an individual. This was perhaps the motivation of the Prophet when he fixed the nisab on various forms of wealth.

So far the disbursement of zakah funds is concerned it has not been left to the whims of any authority, but rather its proceeds have been fixed for eight largely need-based categories, as specified by al-Qur‘an. The Qur‘an says:

"Most surely, the zakah is only for the poor, the needy, for those employed to administer it, for those whose hearts are to be won over, the ransoming of slaves, for the relief of those overwhelmed by debts, in the cause of God, and for the wayfarer: [this is] an obligation from God, and God is All-Knowing, All-Wise"(9:60).

In this verse, the zakah-entitled categories have been consolidated and clearly demarcated so as to remove all sources of vagueness on the issue.

The payment of zakah by the rich is not merely a moral obligation toward God or a basic element of worship and faith. It is also a legal right of certain categories of

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disadvantaged individuals in the society without the rendering of which, one's justification and vindication as a Muslim is both doubtful and questionable.\textsuperscript{105} Furthermore, zakah is not a favour by the rich to the poor. No one except God is the real owner of the wealth. Human beings as the possessors of wealth are merely the trustees as described by \textit{al-Qur'an}.\textsuperscript{106} Therefore, they must spend it in accordance with the terms of the trust, i.e., fulfilling the needs of the poor. The poor should also not treat the receipt of zakah as a personal disgrace because what they are receiving is only their right ordained by God on the wealth of the rich.\textsuperscript{107} They are free to choose how to spend their receipts of zakah on their own priorities within the constraints of the shari'ah.

\textit{Al-Qur'an} views zakah as the opposite of riba in a sense that while the former brings the zakah payer an increase in a beneficial way, the latter brings the lender an increase through an exploitative practice. In terms of distributive effects also the two are opposites. While riba transfers wealth away from society to the rich, zakah redistributes wealth from the well to do to the poor. Besides, the multiplier effect of zakah through increased consumption, output, employment and income cannot be denied. However, zakah is largely a temporary relief measure. It's purpose is twofold: to meet the immediate needs, and to help people stand on their own feet so as to move out of poverty, and to be socially and economically productive. Furthermore, it can place funds at the disposal of the government, which are to be used to create employment potential and thereby permanently eliminate a major source of poverty - unemployment. Zakah funds can also be used for the unemployed poor, the sick, disabled, destitute and young who are unable to help themselves, and are in need of continuous assistance, so as to eliminate misery and

\textsuperscript{105} Al-Qur'an, 41: 6-7.
\textsuperscript{106} Al-Qur'an, 57: 7.
\textsuperscript{107} Al-Qur'an, 51:91; also 70:25.
poverty from the Muslim society. However, if the proceeds of zakah are not sufficient, it is the unavoidable responsibility of society to find other ways and means of attaining the desired goal. 

The most important feature of zakah as a compulsory religious financial duty is that it transfers some of the income and wealth from the rich to the poor as we mentioned in preceding paragraphs, whereas the duties resembling it in other religions are basically meant for financing the functions of religious intermediaries or for the living expenses of clergymen or for the construction and maintenance of places of worship. Another distinguishing feature of zakah is the role of the State in its collection and distribution, which was unusual before the advent of Islam. It is to be noted here that shari’ah has made obligatory the complete separation of the zakah budget from the general budget of the State so that the rights of the poor and other beneficiaries of zakah can be protected. 

So far as the potential distributive effects of zakah is concerned, here a question may arise that how much would be the yield of zakah in modern economy if it was paid on all kinds of assets liable to it? Although we do not have any estimate of this but we may draw the following tentative results from an empirical study made in Syria in 1971 and a similar study conducted in Sudan in 1982.

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a) The possible zakah yield reached about 3% of the gross domestic product in Syria and 3.60% in Sudan.

b) The yield of zakah is relatively high as compared to other major economic variables. It reached 18% of fixed investments in Syria and came to 20% of the current budgetary expenditure while in Sudan it reached 28% of the gross investments and 30% of current budgetary expenditure.

c) The agricultural sector in Sudan had a share of 38% in the gross product whereas in Syria it was 20% but the yield of zakah as a proportion of gross domestic product is similar in the two countries. This is so because other economic activities whose relative importance increased and which replaced agriculture are also subject to zakah.

d) If modern forms of income and wealth are disregarded in the imposition of zakah in the contemporary societies, it will greatly affect the expected zakah yield. To be exact, it seems that this will lower the yield of zakah by more than one-third.

From above results it is found that zakah may amount to 3% of national income each year. If it is assumed that two-thirds of the yield of zakah goes to the poor (while the remaining one-third is spent on other categories), then about 2% of national income can be allocated each year to the poor by way of zakah. If may be mentioned here that in many countries the poorest 10% of the citizens acquire 2% of the national income.\footnote{Zarqa, M. Anas, "Distributive Justice in Islam", in Awan, K. R. and Ausaf Ahmad (eds.), Lectures on Islamic Economics, op.cit., p.153.} Under the circumstances, it is possible to conclude that the share of the poor and destitute in the
potential yield of zakah each year would approximately be the double of the income of those poorest 10% of the society.

So far the implications of the Islamic system of zakah for the economy and its role in distributive justice are concerned, they can be summarised as follows:

First, since zakah has to be paid on net worth, regardless of whether the capital is utilised or not, it forces the capital owner to invest in productive activities - both to be able to pay zakah from profits, as well as to prevent the consumption of capital by zakah.

Second, The zakah levy contributes to economic growth. The exclusion and exemption of the means of production from zakah provides an incentive for increased investment in plant and equipment, and leads to a high level of capital utilisation, which in turn, promote employment, output and income and consequently, economic growth. Similarly, zakah exemption of physical capital encourages economically productive activities vis-à-vis speculative activities.

Third, zakah directly contributes to increased consumption through financing the poorest groups in society. In this way effective aggregate demand goes up significantly. This leads to increased employment, output and standard of living, and consequently, the economy moves toward higher output levels.

Fourth, The very institution of zakah contributes to economic development and growth of the country. The expenditures of zakah for provision of essential public goods and services to those who would not have sufficient access to them increase the income levels of the target beneficiaries as well as the growth potential of the economy, especially when employment is provided for the unemployed.

Finally, zakah has an economic stabilising influence in a sense that in a situation where the economy operates much below its full-employment potential, zakah
expenditures increase aggregate demand, thereby reducing the output gap; and where the economy reaches full employment, the expenditures of zakah are reduced in proportion. On the other hand, if the zakah collection surpluses it can be saved, used for development purposes and transferred to the needier regions of the world.

It is evident that zakah tends to eliminate poverty - both short-term and long-term. In other words, being a collection of redistributive measures it plays an important role in an Islamic economy. That is why zakah has been given so high an importance in the Islamic value framework - as a religious duty, as a moral obligation, as a legal right and duty, and as an economic policy instrument.
Chapter IV

PRINCIPLES OF SHARI`AH LAW IN ISLAMIC BANKING
PRINCIPLES OF SHARI`AH LAW IN ISLAMIC BANKING

4.1 Principles of Islamic Finance

Islam categorically prohibits its followers from dealings that involve *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. Muslims are not averse to legitimate profit and Islam encourages people to use money in Islamically legitimate ventures, not just to keep their funds idle. Keeping this in view, the hallmark of Islamic banking is the prohibition of *riba* or interest, and there is now a general consensus among Muslim economists that *riba* is not restricted to usury but encompasses interest as well. The principles of Islamic finance enshrined from *al-Qur'an* and Prophetic *sunnah* 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 hassan* (literally known as benevolent 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* or loan such as riding the borrower's mule, eating at his/her table, or even taking advantage of the shade of his/her 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*, Islamic finance is based on the premise 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 in sharp contrast to the interest-based commercial banking system, where all the pressure is on the borrower: who must pay back the loan, with the agreed interest, regardless of the success or failure of the bank financed 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).

C. Making money from money is not Islamically acceptable

As Islam views money as 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 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 as such hoarding money is regarded unacceptable. In Islam, money represents purchasing power, therefore, 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 i.e., Uncertainty, Risk or Speculation is also prohibited

Any contract 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 unIslamic 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 hasan. According to those scholars, the creditor advances the loan to win the blessings of God and expects to obtain the reward from God alone. A number of transactions are treated as exceptions to the principle of gharar such as bai’ bi thaman ‘ajil or sales with advanced payment, istisna’ or contract to manufacture and ijara or hire purchase. 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 in Islam.

Investments, according to the rules set by shari‘ah should not be made for the products which are forbidden or even encouraged in 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.

4.2 The Shari‘ah principles for Services and Products of Islamic Banks

The central objective of Islamic banks is to provide banking facilities and services in accordance with Islamic principles, rules and practices. This means Islamic banks provide savings facilities to depositors and extend financing facilities to deficit units. Commercial banks operate by taking of deposits or loans from people who wish to invest and then lending at a slightly higher interest rate to businesses or householders who wish to borrow. As the nature of Islamic banks are similar to that of commercial banks, the functions of Islamic banking are almost the same as conventional banking mainly in terms of accepting deposits from the depositors and operating functions of customers as agents as long as they do not contradict the principles permissible by Islam. Hence, where the conventional commercial banking-practices do not clash with the Islamic principles, the Islamic banks have adopted the traditional banking tools and procedures for their functions. However,
the Islamic banks have devised their own tools and procedures to accomplish their banking activities in accordance with *shari'ah*. Products of Islamic banks are discussed below.

**A. Mobilisation of Monetary Resources**

There is a consensus among scholars and practitioners of Islamic banking that deposits can be mobilised using the following two *shari'ah* contracts that are currently functioning all over the world:

1. *Al-wadi'ah*.

2. *Mudarabah*.

Bank deposits under the principle of *al-wadi'ah* are classified in two different accounts:

a) current accounts deposits, and  b) savings accounts deposits.

Under both accounts, Islamic banks receive deposits from individuals and companies looking for safe custody of their funds, together with convenience and use thereof, on the principle of *al-wadi'ah* or trust. The banks take permission from their clients to make use of their funds while these funds remain with the banks. The clients may withdraw a part or the whole of their balances at any time and the banks guarantee the funds of such balances. All the profits generated by the banks from the use of such funds belong to the banks. For their part, the banks provide the clients with chequebooks and other usual services related with these accounts. However, in contrast to current accounts Islamic banks may, at their absolute discretion, reward the clients of saving accounts deposits by returning a portion of the profits generated from the use of their funds from time to time.

In the case of *mudarabah* principle the bank also accept deposits under two different accounts:
a) the general investment accounts, and

b) the special investment accounts.

Under the general investment accounts Islamic banks accept deposits from clients seeking investment opportunities for their funds. The deposits are held for a specified period. When operating fully, the banks accept deposits for various periods of time. In the case of these accounts, Islamic banks act as entrepreneur, or borrower, and the clients are providers of capital, or lenders. Both agree on how to distribute the profits, if any, generated by the bank from the investment of the funds. As per the rules of mudarabah contract, the loss, if any, incurred in investment, and not due to neglect or misconduct on the part of the bank, is borne by the clients to the extent of the loss. The clients, in most cases, do not participate in the management of investment of the funds.

In addition to the general investment facilities for accepting deposits from its ordinary clients, Islamic banks may also selectively accept deposits from their wealthy individual or corporate clients in the form of special investment accounts. Although these accounts are operated on the principle of mudarabah the modes of investment of the funds and the distribution of profits may be negotiated individually.

Investment accounts can be of two types:

a) accounts with authorisation; and

b) accounts without authorisation.

In the accounts with authorisation, the account holders authorise the bank to invest this money in any one of its projects. After the expiry of a specified period, the account holders will get the profit. In the case of investment accounts without authorisation, the

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The willingness to bear the risk of loss justifies a share in the profit for the clients – the depositors. The banks guarantee to return clients’ money only on two conditions: if they are negligent in the use of money, or they breach the conditions of the contract.
account holders may choose any particular project for investment of their deposited money. The bank will give share to the account holders from the profit of that particular project which had been chosen by them according to agreed percentage.\textsuperscript{115} If the investment accounts are opened for a fixed period, the customers are not allowed to withdraw their money before the lapse of the specified period. If they do so, the customers either are not entitled to the share in profit at all or may be entitled to receive some discounted profit depending upon the duration of the deposit with the bank. These deposit schemes of Islamic banks have been able to attract a substantial number of depositors.

B. Fund Management

Many Islamic banks have created specific funds that operate as trust funds and are considered as an item of the balance sheet. These funds provide the investors with a variety of investment opportunities and provide the banks with substantial income to compensate for their role as entrepreneurs (borrowers) under the shari`ah. Banks that are most active in this area among others are Bank Al-Rajhi of Saudi Arabia, the Kuwait Finance House and the Faysal Islamic Bank of Bahrain.\textsuperscript{116}

C. Granting Services for Correspondent Banks

Islamic banks offer services in the field of international trade and money transfers. In this regard no special relationship is needed beyond providing the correspondent banks with

\textsuperscript{115} The profit-sharing ratio or rates of profit that mutually agreed upon between the client and the bank are worked out by a formula that determines net profit accruing to the bank and allocates to remunerable liabilities according to their maturities. Allocations are based on differential weights assigned to liabilities according to relative maturities.

\textsuperscript{116} Al-Omar, Fuad and Abdel-Haq, Mohammed, \textit{Islamic Banking: Theory, Practice and Challenges}, op. cit., p.32 .
ready balances in a current account to meet the obligations of direct money transfers. The correspondent banks can legitimately claim commission on these services. The Islamic banks may, however ask the correspondent banks to add their confirmation to letters of credit opened on behalf of foreign suppliers to importers in the country where the Islamic banks operate. Suppliers usually ask for this as an added security for their payments. In some cases foreign correspondent banks agree to deal with Islamic banks on the basis of a mutual agreement, initiated and confirmed by a simple exchange of letters, to provide the letter with confirmation facilities up to an agreed ceiling without charging interest. In return for this consideration, Islamic banks undertake to keep a reasonable amount of cash in their current account with the confirming banks and they try to cover any debit as soon as possible.

E. Providing Other Banking Facilities

Islamic banks provide other normal banking services under various principles of shari`ah. The followings are some of them:

<table>
<thead>
<tr>
<th>Type of financing</th>
<th>contracts used to grant financial facilities</th>
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<tr>
<td>Project financing</td>
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<td>Trade financing</td>
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<td>Financing the acquisition</td>
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<td>Other banking services:</td>
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nominee, company services, purchase and sale of gold bullion and foreign currencies, collecting and processing of drafts, promissory notes and bills of lading, purchase and sale of real estate, carrying out agency functions, provision of technical, economic and finance management & marketing consultancy services for preparation of feasibility studies of projects and safekeeping of documents and other valuables.

F. Insurance and Underwriting

Some of the Islamic banks in the world are undertaking ta'min or insurance as a subsidiary business of their institution. Unlike conventional insurance Islamic insurance is based on the principle of takaful or mutual responsibility and ta'awun or cooperative in accordance with shari'ah. The principle is that all the losses have to be borne by the participants on cooperative basis. The participants will, however, share the profit arising out of the investment of the premium. This principle is being applied to life insurance too. The procedure is that all the participants i.e., policyholders at the maturity of their policy get the entire amount that they had paid as premium plus the share in profit. If the policyholders pass away before the maturity of their policy, they get the entire amount that they paid as premium plus the share in profits plus the remaining amount of the policy to be contributed by all the other participants. The participants contribute not only as part of their social obligation but also because they will get the same treatment.
4.3 The Shari‘ah Principles of Operation in Islamic Banks

Like any other financial institutions, the main function of Islamic banks is to mobilise savings and idle funds in the economy and make them available to those who can make better use of them. Since the main raison d’etre of Islamic banking is to conduct financial matters in line with religious provisions thereby conduct worldly affairs in accordance with God’s commandment and to achieve benefits both in this world and hereafter, Islamic banks should be based on elimination of riba. Another salient characteristic of these institutions is the socio-economic orientation of their business policy.117 Although the major two sources of shari‘ah, namely al-Qur’an and the sunnah have given some basic principles for business transactions, these are not directly related to the modern banking system. Therefore, contemporary Muslim jurisprudents have developed appropriate financial instruments without violating the shari‘ah, which aim to implement the outlined objectives of Islamic banking. Their concepts are drawn from Islamic financial practice and were found unobjectionable and subsequently institutionalised in Islamic law. In this regard Muslim theologians and economists have envisaged a number of models of Islamic banking. The common principle of these models is that the operations of Islamic banking have to be based on profit and loss sharing and equity participation.118 Among the most common principles of business transactions which are widely envisaged in theoretical literature on Islamic banking are the principle of mudarabah, musharakah, murabahah, ijarah, bai‘ muajjal, ba‘i salam and istisna‘. The terminology of these principles derives from Arabic. Among these, mudarabah and musharakah were widely practiced by the

118 In the early eighties, there was a growing number of literature on Islamic banking mostly written by the Pakistani economists. They have suggested the alternatives to interest-based activities of a bank, i.e., mudarabah and musharakah.
people at the inception of Islam. Their wide acceptance in early Islamic economic history followed from the Prophet’s implicit acceptance of them. He is recorded as having been a party to the mudarabah contract, and mufawadah (now commonly termed musharakah) was practiced during his time.\textsuperscript{119} While mudarabah appears to have originated among the Arabs, the use of some form of partnership dates back to the time of the Babylonians.\textsuperscript{120} Both of these commercial transactions have now been adapted into financial transactions in Islamic banks.

\subsection{Mudarabah}

The mudarabah\textsuperscript{121}, also known as qirad or muqaradah\textsuperscript{122} is one of the most quoted financial instruments used by Islamic banks. Muslim scholars have used different terminology for this Arabic word when translating into English such as ‘profit-sharing’, ‘trust financing’, ‘trustee profit-sharing’, ‘equity sharing’, ‘funds management’, ‘sleeping partnership’ and ‘commenda’.

The names for this kind of contract are themselves of some interest. The very word ‘mudarabah’ seems to come from an idiomatic phrase that appears in \textit{al-Qur’an}, meaning to beat the earth, or travel a great distance. The words qirad and muqaradah have the sense of cutting off. The investors cut off, or surrender, their use of the capital and entrust it to the mudarib.


\textsuperscript{121} The term mudarabah includes other legal sub-principles such as mufawadah and ‘inan, which have a technically legal character and are not concerned to this study.

\textsuperscript{122} The term qirad or muqaradah is used by other schools of thoughts other than Hanafi one mudarabah, who use it for the same financial technique.
The *mudarabah* is defined as a contract between at least two parties whereby one party, the financier (known as *rabb al-mal* or *sahib al-mal*, i.e., owner of the property) entrusts funds to the other party, the entrepreneur (the *mudarib* or *`amil*), to undertake a business activity. The entrepreneurs return the principal to the financiers with a predetermined share of profit. In the case a loss occurs, the financiers lose some or all of their capital and the entrepreneurs do not receive any remuneration for their labour and effort. In Islamic banking, the *mudarabah* contract has been extended to include three parties: the depositors as financiers, the bank as an intermediary, and the entrepreneurs who require fund. The bank acts as an entrepreneur when it receives funds from depositors, and as financier when it provides the funds to entrepreneurs. For example, the Islamic banks, after receiving funds from their depositors, may enter into a contract with well-established commodity traders who have access to deals but lack capital to execute them. Profits from the deals will be split between the two parties, rewarding the banks for the provision of money and the traders for their expertise. This is called ‘two-tire *mudarabah*’ as the investors pool their funds with the banks that subsequently deal with entrepreneurs. The main conditions related to a *mudarabah* contract are as follows:

1. The banks receive funds from the financiers where no restriction can be imposed on the banks concerning the kind, the duration or the location of the business activity. However, in this contract, deposited funds cannot be invested in activities that are forbidden in Islam. Involvement with such activities would make the contract null and void.

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2. The banks have the right to invest the funds directly in form of own investments or to offer them to other entrepreneurs.

3. The banks have the right to aggregate the profits from different investments, and share the net profit with the depositors according to a predetermined ratio. In the event of losses, the depositors lose a proportional share or the entire amount of their funds.

4. The banks have the right to determine the kind of activities, the duration, and the location of projects and supervise the investment when funds are provided to entrepreneurs, provided these are not formulated in a way that harms the performance of the entrepreneurs. However, when a project is undertaken, the banks may not interfere with the management of the investment.

5. The banks cannot seek any guarantee from entrepreneurs to secure their capital against an eventual loss. Such a condition makes the contract null and void.

6. The liability of financiers is exclusively limited to the amount provided, whereas entrepreneurs' contribution is restricted solely to their labour and effort. If negligence or mismanagement of the entrepreneurs can be proven, they may be made liable for the financial loss and thus be obliged to compensate the financiers.

7. The entrepreneurs share the profit with the banks according to a previously agreed ratio. Until the investment yields a profit, the banks have the possibility of paying a salary to the entrepreneurs. The salary is determined on the basis of the current job-market salary.

It should, however, be pointed out that mudarabah is of limited scope and risky for banking. Banks, even if they are nationalised, cannot work successfully under this financial instrument. Because, the entrepreneurs, being the skilled persons must be free to
act within the authority, and as such, nobody not even the state can interfere in their activities. The funds as stated above, must be completely made over to them so that they may handle it on their own. The financiers are not allowed to participate with them in work, nor are the entrepreneurs authorised to invest anything of their own so as to become financiers themselves. Entrepreneurs, as explained above, cannot be expected to furnish security for the capital made over to them. Even if they are made to furnish such security, it will be of no use to financiers because according to the rules of mudarabah, the entire loss attributed to financiers and they cannot fall back upon the security to recover it.

4.3.2 Musharakah

The musharakah is normally translated in English as ‘partnership’. In the context of Islamic banking, however, the musharakah means ‘participating financing’ or ‘equity participation’. It is relatively new term in Islamic commercial law. Literally, it means a joint-venture agreement between two parties to engage in a specific business activity with an aim of making profit. In other words, it is a participative arrangement in which all partners contribute to capital. Unlike mudarabah, they are entitled to participate in management but not necessarily required to do so. Profit is to be distributed among the partners in ratio agreed to by the partners in advance, while loss is borne by each partner strictly in proportion to the capital contribution.

The musharakah corresponds in many ways to its conventional counterpart, but there are important differences. There are two kinds of musharakah - one is mufawadah or universal partnership, in which complete equality of investment and profit and loss is obligatory; and the other is inan or limited investment partnership into which all other
types of partnership fall. Under an 'inan arrangement, each partner is the agent but not the guarantor of the other, and the agency applies only to the field of business for which the partnership has been established, and to the extent of their joint capital. The 'inan form of musharakah is the form used by the Islamic financial institutions today. The institutions usually translate musharakah as participation rather than partnership, and it is in the sense of participating in the borrower's profits, in return for the provision of capital, that the musharakah has come into its own, rather than as a working partnership in which both sides contribute the same kind of input.

A typical form of the musharakah is used by some Arab Islamic banks. The bank and the would-be borrower agree to a participation of limited duration, perhaps to finance the expansion of an existing industrial venture. Both parties contribute to the capital, in the sense of financial assets, including working capital and technical and managerial expertise, agreeing in advance to divide the net profits in a proportion they have negotiated between themselves. The time scale can vary from weeks to years, with medium and long-term operations generally being self-liquidating. As the bank gradually withdraws its principal and agreed profits the participation agreement is phased out and the entrepreneur is left with sole ownership. Some other Islamic banks, for instance, Dar al-Mal al-Islami (DMI) foresee other uses of the musharakah, such as in the provision of general-purpose finance. Some 90% of such finance is supplied as an interest-free loan due on a fixed date, secured by a real estate mortgage or other security. The balance buys a participation in profits expressed as a percentage of gross sales during the period when the interest-free loan is outstanding. Although the gross sale formula eliminates problems of

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124 Such a form of musharakah is used by the Faysal Islamic Bank of Sudan. See Roger Cooper, “A Calculator in One Hand and the Koran in the Other”, Euromoney, November 1981, p.44.
accounting, which are always, a potential problem in Islamic profit-sharing schemes but the transaction could be held to be disguised *riba*. The generally agreed terms of the *musharakah* are as follows:

1. All partners must contribute capital to the partnership.
2. The contribution of capital can be made either in the form of cash or in material provided that its cash value can be established prior to employment in the partnership.
3. The contribution must be subject to profit sharing in any ratio agreed between the partners. A fixed amount of profit must not be agreed as part of the profit-sharing agreement.
4. The partners' losses are to be shared according to the financing share of each partner and may not be limited to the value of their capital contributions.
5. The Partnership may be agreed for a particular period of time or be indefinite. It can be established as permanent *musharakah* in which invested funds are not subject to repayment in the short term, or as *musharakah* *mutanaqqisah* or diminishing partnership where invested funds are repaid over time as profitability allows. Such divestment terms are agreed at the outset.
6. It may be agreed that the termination of the *musharakah* can only occur with the mutual agreement of all partners, though some jurists argue that one partner on his or her own may require the dissolution of the *musharakah*. Such a possibility seems to hold out rather dangerous implications for those partners wishing to continue with a business endeavour, especially in the early stages of the partnership and has therefore been rejected by many jurists as an unsound basis for partnership.
7. Partners must receive regular accounting and other information on business activity.

8. Permission from existing partners is required before raising capital from new partners.

9. Partners may negotiate fixed wages or salaries at the outset of the *musharakah*.

### 4.3.3 *Murabahah*

The *murabahah*, variously translated as fixed profit sale and cost plus profit, is particularly well suited to importers who need to finance goods from the moment of their order or the shipment of goods, until they receive them and can sell them. The commonest form of sale in medieval Islam was the *musawamah*, or sale at a price mutually agreed upon by buyer and seller, but there were three other forms of sale, all based on the cost of the object to the seller. Muslim scholars have not been able to determine the exact function of them in the medieval marketplace. These are the *tawliyah*, or resale at the stated original cost without profit or loss to the seller, the *wadi‘ah*, or resale at a discount from the original cost, and the *murabahah*, and it is the last of these that has found a new function.

The word *murabahah* comes from a root meaning ‘profit’, and a *murabahah* sale involves the purchaser agreeing to buy an item from the vendor with a fixed surcharge or profit added to the original cost. Customers request the Islamic bank to buy an item they require at a specific price, which in practice they have probably negotiated themselves. They later buy it from the bank at the agreed higher price. For example, a coffee importer who wants to use Islamic finance rather than a conventional interest-bearing loan would ask a bank to purchase on its behalf a shipment of coffee. The bank would make the
purchase, take title to the coffee and resell it to the importer. The importer would receive the goods immediately but would be allowed to defer payment to the bank. The bank would charge a fee to cover its work on the transaction and the cost of the deferred payment. According to the practice of the some Islamic banks,\(^{125}\) neither the agreement of the bank to buy nor the purchase itself obliges the customer to buy, although some Muslim jurists take the view that it is not a true murabahah unless the customers buy. On the other hand, the risk element is undoubtedly there until the customers fulfill their original promise, protecting the seller from any accusation of disguised riba. The disadvantage is that the institution has to ensure that the goods are marketable, since it may have to resell them to a third party.

Among the essential conditions of a murabahah are that both parties should know the original purchase price, that they should know the rate of profit, and that interest should not be included in the original purchase price. Where it is practiced in the modern financial market, murabahah usually obeys the following terms:

1. The end user settles the amount outstanding in one lump sum upon delivery or thereafter.

2. The settlement date must be specified.

3. The financier maintains ownership of the purchased items until delivery.

4. The financier bears all the costs and risks of ownership until delivery.

5. The end user and financier must pre-agree and specify the mark-up to be applied.

6. The mark-up applies to all relevant costs incurred by the financier.

7. The goods subject to the transaction must be specified.

\(^{125}\) Ibid., p.60.
8. The cost of the required items, and other relevant costs, must be specified prior to contracting.

9. In the event of default by the end user, the financier only has recourse to the terms financed, and no further mark-up or penalty may be applied to the sum outstanding.

10. The item purchased by the financier cannot be under the ownership of the financier but must instead belong to a third party at the time of contracting.

11. The seller may require the buyer to furnish security for the payment due but only at the time when delivery of the purchased items to the buyer is made.

The murabahah is extremely flexible, since the surcharge or rate of profit can be varied, depending on whether the customer wishes to pay against delivery or pay by installments. In the latter case, a mortgage of real estate may be required, or the goods could remain in the custody of the institution to be released as required by the market. In practice, the murabahah of an item of capital equipment is virtually indistinguishable from an ijarah or leasing contract.

4.3.4 Ijarah

The Ijarah literally means ‘to give something on rent’. Technically, ijarah is the ownership of a specific benefit, while carrying a known cost. From a shari’ah point of view, ‘a specific benefit’ means an identifiable and actual economic benefit from the assets. While the second part of the definition ‘a known cost’ is meant a pre-agreed and non-variable cost unless as part of a new lease contract. This is a general definition of ijarah.126 Its

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specific definitions are many, but here we shall concentrate on two relevant of them only. The first is *ijarah* or true lease, which represents an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred. The second type is *ijarah wa iqtina* (literally, ‘lease and ownership’). This is a lease whereby the lessee derived economic use and ultimate ownership on the nature of a higher purchase. This is equivalent to a financial lease, or a lease with a purchase option. The purchase option stems from either a portion of the rental being allocated to a capital savings account, or a pre-agreed balloon payment, at the end of lease. For example, an Islamic bank agrees to buy and rent a building, equipment or other facility for its client, in conjunction with an undertaking by the client to make incremental payment into an account. At the end of each year, profits are added to the instalments paid until such time as the investment account contains the identical amount the bank paid to purchase the building equipment or facility. The client becomes owner of the financed equipment and the contract ends. However, some jurists do not permit this latter arrangement on the basis that it represents more or less a guaranteed financial return at the outset to the lessor, in much the same way as a modern interest-based finance lease. To be acceptable in an Islamic framework, the leasing contract must meet certain conditions. The principal ones are the following:

1. Assets leased must have an active, and physical use. An asset that lies dormant and has no real use cannot be leased in accordance with the *shari`ah*.

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127 Ibid., p.88.
2. A real benefit must be derived from the assets leased.

3. The service that the leased property is supposed to provide and for which it is being leased should be defined and pre-agreed. It must preclude speculation.

4. The tenure of the lease must be related to the actual economic life of the assets.

5. The leased property remains in the ownership of the lessor who is responsible for its maintenance and insurance throughout so that it continues to give the service for which it was leased.

6. The leasing contract is terminated as soon as the asset becomes damaged during the period of the contract the contract will remain valid.

7. Leases must not be used on any form of *riba*.

8. The price of an asset that may be sold to the lessee at the expiry of the contract cannot be pre-determined. However, lessor and lessee may agree the continuation of the lease or the sale of the leased asset to the lessee under a new agreement at the end of the initial lease period.

9. In the event of late payment of rental, the *ijarah* may be terminated immediately.

4.3.5 *Bai` Muajjal*

The term *bai` muajjal* literally means 'sale on a deferred-payment basis'. In the modern Islamic banking system, it is a variant form of trade dealing, which the seller allows the buyer to pay the price of the commodity purchased (permissible under Islamic *shari`ah* and law of the country) on deferred basis in lump sum or instalments. The seller may sell on deferred basis with or without a profit margin, with a profit margin above or below the
current market rate of profit, or even below cost, as may be agreed to between him or her and the buyer. Thus, \textit{bai` muajjal} does not necessarily involve a mark-up on price for the time involved till actual payment, although mark-up is permissible in principle. Moreover, no extra charge on agreed price is permissible if the buyer defaults on the due date of payment. The seller has only two choices: either he or she may allow further time to the buyer to pay the agreed price or have recourse to the court of law.

Since the concept of \textit{bai` muajjal} is based, one-way or the other, on a mark-up in price, it is also known as \textit{murabahah}. But it is used in some countries like Malaysia and Bangladesh separate and distinct from \textit{murabahah} for its specific purpose. Islamic banks in Malaysia, instead of using \textit{bai` muajjal} use another terminology i.e., \textit{bai` bithaman aajil} (BBA). The classical difference between \textit{bai` muajjal} and \textit{murabahah} is that in \textit{murabahah}, the buyer needs to be informed by the bank as to the cost price of the commodity. Otherwise the buyer can terminate the contract. But it is not a requirement for \textit{bai` muajjal} contract. While the difference in modern practice is that \textit{murabahah} is for short time financing while \textit{bai` muajjal} is for the acquisition of assets for a longer period of time. The second difference is lump sum versus instalments. The \textit{murabahah} is a deferred payment in lump sum while \textit{bai` muajjal} is a deferred payment by instalments.

As \textit{bai` muajjal} and \textit{murabahah} contracts fall under the category of sale, the following conditions of sale as per the \textit{shari`ah} are applicable:

1. Object must be in existence. Otherwise, the contract is null and void;
2. Object must be owned and possessed by the seller (bank);
3. Sale is instant and absolute. It is not pending on future date/event;
4. The price is certain; otherwise, it will tantamount to two sales in one sale, which is prohibited by the Prophet;
5. No conditions attached.

The *bai` muajjal* stems form *shari`ah* principle, which permits a trader to sell goods for cash or on credit on the condition that the price, once agreed between the parties at the time of bargain, is not changed even if the payment is not made at the due date. In such a case, if the client delays payment on due date, the Islamic bank would not be getting any return on its investment for the delayed period. Therefore, the greatest shortcoming of *bai` muajjal* investment is that some of the clients might intentionally delay payment so as to gain monetary benefit from such transactions. In certain cases they may have even genuine problems, such as their cash flow may not permit payment. However, this problem can be solved that while sanctioning the limits if the bank takes utmost care in assessing (i) the credit-worthiness, in particular straightforwardness or otherwise in dealing of the clients, (ii) marketability of the commodities sold or goods manufactured therefrom, (iii) their cash flow chart and (iv) securities offered to doubly ensure that payment would be forthcoming by due date.

**4.3.6 Bai` al-Salam**

The term *bai` al-salam* means ‘advance payment’ or ‘forward buying’. It is a contract for deferred delivery that was originally sanctioned during the time of the Prophet, to facilitate the trading activities of farmers who were awaiting the harvest of corps. In more modern times it has also been applied to the production of raw materials and fungible goods in general. The generally agreed conditions for the validity of *bai` al-salam* are as follows:

1. The goods sold need not be in existence at the time of contracting.
2. The delivery date must be specified.
3. Full advance settlement of the agreed sale price is required at the time of contracting; otherwise the contract would sanction the trading of one debt for another, which is not deemed permissible in Islam.

4. The quality of the items delivered should be defined. Items must be fungible in nature. Hence, rare items, or those that are not precisely specifiable, cannot be the subject of the bai‘ al-salam contract. If the quality of the items upon delivery is found to be other than specified, the buyer has the right of refusal.

5. The quantity of the items to be delivered should be defined and fixed according to the normal method of measurement of those items and should not depend upon unforeseeable factors. The quantity of goods purchased under the bai‘ al-salam contract cannot, for example, be defined as that resulting from the cultivation of a given plot of land since such a quantity may vary according to unforeseeable factors.

6. The delivery site and delivery date should be defined and fixed.

7. The buyer does not enjoy ownership of the goods until delivery has taken place.

8. The buyer has the right to take surety from the seller as a form of performance bond.

9. Where the seller is unable to produce the contracted items on the delivery date, the buyer may nullify the contract and exercise the performance bond.

10. The seller may deliver the contracted items irrespective of the buyer’s circumstances on the delivery date.
4.3.7 *Istisna*¹

*Istisna*¹ is a new concept in modern Islamic banking and finance that offers a number of future structuring possibilities for trading and financing. It is basically a contractual agreement for processed goods and commodities, allowing cash payment in advance and future delivery, or a future payment and future delivery. This flexibility allows the bank to pre-sell to its clients for future delivery on a cash-on-delivery basis and then negotiate the purchase.¹³⁰ General agreement upon principles of the practice of *istisna*¹ is difficult to identify. However, it is often stated that:

1. the nature and quality of the item to be delivered must be specified;
2. the manufacturer must make a commitment to produce the item as described;
3. the delivery date is not fixed, the item is deliverable upon completion by the manufacturer;
4. the contract is irrevocable after the commencement of manufacture except where delivered goods do not meet the contracted terms;
5. payment can be made in one lump sum or instalments, and at any time up to or after the time of delivery; and
6. the manufacturer is responsible for the sourcing of inputs to the production process.

*Istisna*¹ differs from *ijarah* in that the manufacturers must procure their own raw materials. Otherwise, the contract would amount to a hiring of the sellers’ wage labour as occurs under *ijarah*. It also differs from *bai*² *salam* in that a) the subject

matter of the contract is always a made-to-order item, b) the delivery date need not be fixed in advance, c) full advance payment is not required, and d) the ʻistisnaʿ contract can be canceled but only before the sellers commence manufacture of the agreed item.

Besides the above-mentioned principles, there are many other shari`ah principles governing the operations of existing Islamic banks. These principles sometimes are either used by a limited number of Islamic banks or by the Islamic banks in specific countries.\textsuperscript{131} Among the principles within this category are ʻbai` al-dayn, al-wakalah, al-hiwalah, al-kafalah, qard hasan, wadi`ah, rahn, al-ujr, and al-ju`alah.

\textsuperscript{131} Haron, Sudin, Islamic Banking: Rules and Regulations, op.cit., pp.85-86.
Chapter V

DOCTRINE OF RIBA: AN OVERVIEW
DOCTRINE OF RIBA: AN OVERVIEW

5.1 What is Riba?

Riba is an Arabic word, derived from the verb raba that literally means ‘to grow’ or ‘expand’ or ‘increase’ or ‘inflate’ or ‘excess’.\(^{132}\) The same literary meaning has occurred in many places of al-Qur’an as well.\(^{133}\) It is, however, not every growth or increase, which falls in the category of riba prohibited in Islam. It is generally translated into English as “usury” or “interest”, but in fact it has a much broader sense in shari’ah.\(^{134}\) Riba in the shari’ah, technically refers to the ‘premium’ that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity.\(^{135}\) In fiqh\(^{136}\) terminology, riba means an increase in one of two homogeneous equivalents being exchanged without this increase being accompanied by a return\(^{137}\). The term riba is, however, used in shari’ah in two senses. The first is riba al-nasi’ah and the second is riba al-fadl.\(^{138}\) Some Muslim scholars attempt to define riba which seems to be closer to the sense implied in the verses of the Qur’an and ahadith related to it. They define riba as an increase or excess which, in an exchange or sale of a commodity, accrues

\(^{132}\) Al-Raghib Al-Isfahani, Al-Husain, Al-Mufradat Fi Gharab al-Qur’an, Cairo, 1961, pp.186-187. The same meaning is also unanimously indicated in all classical Arabic Dictionaries, and in the commentaries of al-Qur’an as well.

\(^{133}\) Al-Qur’an, 30:39; 23:50; 2:265,276.

\(^{134}\) For detail discussion on riba from shari’ah perspective, see section 2 and 3 of this chapter.


\(^{136}\) Muslim jurisprudence based on the Qur’an and the sunnah and secondarily on ijma’ and ijihad.


\(^{138}\) Riba al-Nasi’ah is the riba which the Prophet referred to when he said: “There is no Riba except in nasi’ah” or waiting (Bukhari, Kitab al-Buyu’, Bab Bai’ al-Dinar bi al-Dinar nasa’an; also Muslim, Kitab al-Musaqat, Bab Bai’al-Ta’am Miqlan bi Mithlin). While the authority for the definition of Riba al-Fadl lies in what the Prophet said in more than one occasion: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt – like for like, equal for equal, and hand to hand; if the commodities differ, the you may sell as you wish, provided that the exchange is hand-to-hand” (Muslim, Kitab al-Musaqat, Bab al-Sarf wa Bai’ al-Dhahab bi al-Waraq Naqdan; also in Tirmidhi).
to the owner (lender) without giving in return any equivalent counter-value or recompense to the other party.  

In the pre-Islamic and early Islamic era, *riba* signified the increase of money in consideration for an extension of the term of maturity of a loan. The pre-Islamic and early Islamic Arabs used to pay the money on loans and received a certain sum leaving the principal sum untouched. When the maturity date expired, they would claim the principal sum from the debtor; if it was not possible for the debtor to repay, they would increase the principal sum and extend the term. Thus there were transactions with a fixed time limit and payment of interest, as well as speculations of all kinds that formed an essential element in the trading system of the pre-Islamic era. A debtor who could not repay the debt i.e., money or goods, with the accumulated interest at the time it fell due was given an extension of time during which to pay, but at the same time the sum due was doubled. This is referred to clearly in *al-Qur'an*,

“O you who believe! Do not devour *riba* multiplying it over, and observe your duty to Allah that you may prosper” (3:10).

5.2 The Prohibition of *Riba* in the *Qur'an*

The prohibition of *riba* in *al-Qur'an* developed gradually and appeared in four revelations. The first revelation was revealed in Makkah before the prohibition of *riba* for which the verse paved the way. It says:

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“And whatever you lay out with the people in order to obtain an increased return, this increases you nothing with God, but whatever you give in alms, seeking God’s pleasure, it is those who receive multiplied recompense”, [Chapter al-Rum (The Romans) 39].

The second revelation was revealed in Madinah, which mentions riba:

“Because of the sinfulness of the Jews, We have forbidden to them certain good things that were permitted to them, and for their hindering many from God’s Way. And for their taking riba, though they were forbidden, and that they devoured people’s wealth in falsehood, and We have prepared for the unbelievers among them a grievous chastisement” [Al-Nisa (Women), 160-161].

This revelation created some misunderstanding among the scholars as to whether the prohibition is directed to Muslims or to the Jews in Madinah. The argument that the prohibition is directed to Muslims rather than the Jews seems to be stronger as because the discontentment with riba first occurred while Prophet Muhammad (pbuh) was still in Makkah and there were very few Jews in Madinah at that time. Besides, the Jews in Madinah were mostly involved in the agricultural sector and not in the commercial sector.

An express of prohibition follows in Chapter Al ‘Imran (The Family of Imran), which mentions riba and bans it for the first time:

“O you who believe! Do not devour riba multiplying it over, and keep your duty to Allah that you may prosper” [3:130].

This was the first verse revealed in Medina to impose a ban on riba. In interpreting this verse, the exegetes agreed that expression ‘multiplying it over’ does not restrict the ban but expresses riba which people were accustomed to practice, assuming that this
matter of multiples of multiples is no more than a description of state of affairs and not a condition relevant to the imposition.\footnote{Qutb, Sayyid, \textit{Fi Zilal al-Qur'an}, Beirut, 1997. p.60.}

The prohibition of \textit{riba} was intensified in Chapter \textit{al-Baqarah} (The Heifer). The verses in question, the last to be revealed in Madinah concerning the prohibition of \textit{riba} reads as follows:

"Those who devour \textit{riba} will not stand except as one whom Satan has driven to madness by his touch will stand. That is because they say: ‘Trading is like \textit{riba},’ and God has allowed trading and forbidden \textit{riba}. So to whoever takes the admonition from his Lord, then he desists, he shall be pardoned for the past, and his affair is committed to God, but whoever reverts, those are the inhabitants of the Fire, to dwell therein forever. God will deprive \textit{riba} of all blessing, and will give increase for deeds of charity; for God does not love any ungrateful sinner. Surely those who believe and do righteous deeds and establish prayer and pay alms, they shall have their reward with their Lord, and they shall have no fear, nor shall they sorrow. O you who believe! Keep your duty to God, and relinquish whatever remains from \textit{riba} if you are indeed believers. But you do not, then be warned of a war from God and His Messenger, yet if you repent you shall have your capital fairly. And if the debtor is in difficulty grant him time until it is easier for him to repay, but if you are able, write off the debt as an act of charity, it would be better for you, if only you knew. And guard yourself against a Day in which you will be brought back to God, then every soul shall be recompensed in all fairness for what it has earned, and none shall be dealt with unjustly". [2:275-281]

In these verses \textit{riba} is severely condemned and prohibited in the strongest possible terms. As instructed by \textit{al-Qur'an} (in verse 280), creditors are urged to deal justly and
fairly with debtors. In the event of debtors unable to pay their debt, the creditors are asked: (a) to give up even for claims arising out of the past on account of riba, (b) to give time for payment of principal if a debtor is in financial difficulties or, (c) to write off the debt altogether as an act of charity.

Thus, the verses mentioning riba show that all unlawful accumulation of wealth at the expense of others is condemned, and many different practices either by individuals or nations are covered by this ban. The principle is that any profit that human beings seek should be through their own exertions and not through the exploitation of others. *Al-Qur'an* regards riba as a practice of unbelievers, it demands, as a test of belief, that it should be abandoned.

The above-mentioned verses prohibiting riba make no distinction between production and consumption loans. However, it may be suggested that this was because at that time loans were taken only for consumption purposes. Though much more research is needed, a good deal of documentary evidence has been adduced in recent years to show that loans for production purposes did exist during the time of the Prophet. It has been shown that Arab traders at that time had close ties with the political and economic life of Middle Eastern countries where loans for production purposes had been common for hundreds of years. Historical records also show that on account of political conflicts between Rome and Persia, Arab traders of Makkah often worked as the *via media* for Roman trade with China, Indonesia, India, and Eastern Africa in the period close to the time of the Prophet. It is difficult to imagine, therefore, that loans for production purposes were absent in such conditions. Most of the commentaries on above mentioned verses relating to riba that have come down to us from scholars close to the time of the Prophet
also make it explicit that loan transactions for business purposes involving *riba* did exist at that time.\footnote{See in this connection, Sayyid Quth, *Tafsir Ayat al-Riba*, Beirut: Dar al-Buhuth al-`Ilmiyyah, undated.}

However, the absolute prohibition of *riba* in *al-Qur’an* is a command to establish an economic system from which all forms of exploitation are eliminated, in particular, the injustice of the financier being assured of a positive return without sharing the risk, while the entrepreneurs, in spite of their management and hard work, is not assured of such a positive return. The prohibition of *riba* in *al-Qur’an* is therefore, a way to establish equity between the financiers and entrepreneurs. So, any attempt to treat the prohibition of *riba* as an isolated religious injunction and not as an integral part of the Islamic economic order with its overall ethos, goals and values is bound to create confusion.

### 5.3 The Prohibition of Riba in the Sunnah

*Al-Qura’n* neither defines *riba* nor provides any detailed explanation about *riba*. The *hadiths* that deals with the subject are numerous, although sometimes the content of a particular *hadith* is slightly different from one narrator to another. So it will be sufficient to mention only some of them. The term ‘*riba*’ is considered by *al-Qur’an* as ‘*riba al-nasi`ah*\footnote{‘*Nasi`ah*’ is elated to the verb *nasa’a*, meaning to postpone, defer or wait.} or delayed payment interest whereas the *hadith* explains ‘*riba al-fadl*’ or increase interest.\footnote{The first time the Prophet dealt with *riba al-fadl* was when the tribe of Thaqif claimed repayment of its debt from the tribe of Mughira, a debt which remained from the pre-Islamic *riba*. The Prophet told the Thaqif that the *Qur’an* had ordered the abandonment of the remnants of pre-Islamic *riba*. The second time the Prophet dealt with the subject during his farewell pilgrimage. He said, “*Every riba is disparaged, and the first riba I disparage is ours.*”’Abbas Ibn ’Abd al- Muttalib’s *riba* - (i.e., Prophet’s relatives’ *riba*). It is all disparaged”.} The former refers to the time allowed to the borrower to repay the loan in return for addition or financial increment whether it is a fixed or a variable percentage
of the principal, an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. While the latter occurs when an item, available at the place of sale, is sold for an item, which is not available at the place of sale, even if the two items are exchanged for equal quantity in order to avoid increase interest. Equality in exchange of both items is not a condition here, owing to their dissimilarity. In practice, the *hadith* discusses both types of *riba* - *al-nasi`ah* and *al-fadl* - but its role in regard to the first kind is one of enforcement of God’s commandment and assertion of what is banned.

The view on *riba al-nasiah* is laid down in a number of *hadiths*, but the following is the most famous and accepted one,

“Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, the like for the like, hand to hand (i.e., immediate sale), (but) if the kinds differ, then sell as you may like it from hand to hand.”\(^{144}\)

Another *hadith* is one narrated by Abu Sa`id al-Khudri from the Prophet who said:

“Do not sell gold for gold, except when it is like for like, and do not increase one over the other; and do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away (from among these) for what is ready.”\(^{145}\)

Therefore, if gold, silver, wheat, barley, dates and salt are exchanged against themselves they should be exchanged on the spot and be equal and alike. Of the six specified commodities, gold and silver unmistakably represent commodity money whereas the other four represent staple food items. Muslim jurists have debated the question of

\(^{144}\) Prominent Muslim jurists - Ahmad, Bukhari, Muslims and others related this *hadith*.

\(^{145}\) Bukhari, op. cit., Kitab al-Buya`, Bab Bai` al-Fiddah bi al-Fiddah; also, *Sahih Muslim, Sunan al-Tirmidhi, Sunan al-Nasai* and *Musnad* of Ahmad.
whether *riba al-fadl* is confined only to these six items or if it can be generalised to include other commodities. Given the wide use of gold and silver as commodity money, the general conclusion is that all commodities used as medium of exchange enter the field of *riba al-fadl*. With respect to the other four items there is a difference of opinion among the Muslim scholars. However, the important point is, firstly that these considerable differences are a normal phenomenon in Islamic jurisprudence; and secondly, and much more importantly, in spite of these differences, the opinion of the majority of Muslim jurists is by no means likely to justify *riba al-nasi'ah* or *riba al-fadl*. All Muslim jurists are unanimous in their condemnation of *riba* and are backed by both *al-Qur'ān* and the *hadith*, the main sources of the Islamic *shari'ah*. A legal ruling issued by the Islamic scholars in the second conference of Islamic Researches Academy in 1965 practically and unequivocally, provides strong support for the complete agreement on the ban on *riba*.\(^{146}\) Later, the *Fiqh* Academy of the Organaisation of Islamic Conference (OIC) supported the restrictive interpretation of *riba*, which had been adopted by the early jurists, condemning all interest-bearing transactions as void.\(^{147}\)

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\(^{146}\) Ahmed, Osman Babikir, *The Contribution of Islamic Banking to Economic Development: The Case of The Sudan*, op.cit., p.32.

5.4 Modernists Versus Conservatives’ Views\textsuperscript{148} on Riba

The origin of one part of the controversy between the modernists and the conservatives’ views on \textit{riba} dates back to early Islam, and it revolves around the question of what kind of \textit{riba} the Qur’an really prohibited? Was it \textit{riba al-nasi’ah}, which involves lending and borrowing, or \textit{riba al-fadl}, which involves buying and selling?\textsuperscript{149} One view is that in the early period of Islam, the Qur’anic injunctions against \textit{riba} was understood to apply to loans in money and food, and anything beyond that is accepted to be later development.\textsuperscript{150} Another authoritative view is that \textit{riba al-fadl} has its origin in the \textit{hadith}, and concludes that no attempt to define \textit{riba} on the basis of the \textit{hadith} has really been successful.\textsuperscript{151} A more recent contribution claims that \textit{riba} in both sales and loans existed before Islam, and \textit{al-Qur’an} clearly implies that. Furthermore, the \textit{hadith}, and the juristic formulations, therefore, are elaborations and extensions of the basic Qur’anic concept. It is also argued that \textit{riba al-fadl} is merely a consequence of \textit{riba al-nasiah}, since money can always be transformed into commodities.\textsuperscript{152}

The controversy in its contemporary form turns on the definition of \textit{riba} itself, whether the \textit{riba} merely attached to profits obtained through interest-bearing loans involving exploitation of the economically weak by the strong and resourceful, or through all kinds of loan irrespective of the purposes; whether the prohibition is the form of \textit{riba}.

\textsuperscript{148} The term ‘modernists’ is referred to in this study some contemporary Muslim scholars like Fazlur Rahman (1964), Muhammad Asad (1984), Sa’id al-Najjar (1989), Sayyid Tantawi (1997) and others for whom it appears that prohibition of \textit{riba} is due to the exploitation of the needy, rather than the concept of the interest rate itself. Keeping this in view, many of them attempt to differentiate between various forms of \textit{riba} practiced under the conventional banking system, advocating the lawfulness of some and rejecting others. While conservatives’ views are referred to the traditional interpretation of \textit{riba} which stresses on the point that any kind of interest falls under the banning of \textit{riba}.


\textsuperscript{150} Schacht, Joseph, \textit{An Introduction to Islamic Law}, Oxford, 1964, p.147.

\textsuperscript{151} Rahman, Fazlur, "Riba and Interest", \textit{Islamic Studies}, No.1, March 1964, p.30.

practiced in the pre-Islamic period; whether it prohibits usury but not interest or it prohibits the charging of interest altogether; whether it relates to loans for consumption or investment in a business venture; whether it prohibits nominal or real interest; whether the prohibition applies to compound or simple interest; and whether the ban relates to the borrower as individual or institution. According to the modernists’ trend towards *riba*, extra charges are permitted where they are used:

1. for the purposes other than exploiting the weak people of the community by the strong;
2. for loans that are similar to what were practiced in the pre-Islamic period;
3. for usurious transactions but not the present form of interest-based banking transactions;
4. for consumption loans but not what are used for business investment;
5. for the loss suffered by the creditor due to inflation;
6. for compound interest but not for simple one; and
7. for institutional credit.

As opposed to this rather pragmatic viewpoint, the conservatives view forbids every form of fixed and predetermined interest. They regard the levy of any fixed amount in excess of the principal lent prohibited by *al-Qur’an*. According to this view, since interest, however exorbitant or reasonable, is additional to the principal borrowed, it is a form of *riba* and therefore does not comply with *al-Qur’an*. Thus, *riba*, is defined as any predetermined fixed return for the use of money. Three main reasons are stated for strict condemnation of *riba* in Islam:

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1. Riba reinforces the tendency for wealth to accumulate in the hands of a few, and thereby diminishes human beings concern their fellow men.

2. Islam does not allow gain from financial activity unless the beneficiary is also subject to the risk of potential loss; the legal guarantee of at least nominal interest would be viewed as guaranteed gain.

3. Islam regards the accumulation of wealth through interest or usury as selfish compared with accumulation through hard work and personal activity.

Several modernists and conservatives’ views in regard to the riba along with their arguments are discussed below:

A. Riba is Prohibited for Exploitation and Injustice

Modernists tend to emphasise the moral aspect of the prohibition of riba, and argue that the rationale for this prohibition as formulated in al-Qur’an was injustice and hardship. They also find some support for their views in the works of some early scholars like Imam Razi and Ibn Qayyim for whom it appears that what is prohibited is the exploitation of the needy, rather than the interest itself. Many writers of this trend attempt to differentiate between various forms of interest practiced under the conventional banking system, advocating the lawfulness of some, while rejecting others.

As opposed to this view, it might be argued that the rationale for the prohibition of riba in al-Qur’an is to establish an economic system from which all forms of injustice and exploitation are eliminated, in particular, the injustice of the financiers being assured of a

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156 Al-Qur’an, 2:279.
159 Saleh, Nabil A., Unlawful Gain and Legitimate Profit in Islamic Law: Riba, Gharar and Islamic Banking, Cambridge, 1992, p.34.
positive return without putting any effort or sharing in the risk, while the entrepreneurs, in spite of their management and hard work, is not assured of such a positive return. The prohibition of *riba* is therefore a way to establish justice between the lenders and borrowers.

**B. What is Prohibited is Pre-Islamic *Riba***

It has been claimed by some modernists that what is prohibited in *al-Qur’an* is the form of *riba* referred to the then prevailing practice of lending in the pre-Islamic era. Charging *riba* is found to be peculiar to pre-Islamic times and Arab territory. The debtor had to pay a fixed amount above the principal to the creditor for the use of money loaned for a certain period. This additional amount, which could be more than double the principal sum due, was prohibited by the Qur’anic injunction. According to this view, the first increase in a termed loan is lawful, but if, at maturity date, it were decided to postpone that maturity date against a further increase this would be prohibited. This view is apparently based on the reports came in *tafsir* (the commentary on *al-Qur’an*) of Ibn Jarir al-Tabari in relation to how *riba* was practiced in the pre-Islamic period. However, it does not explicitly and openly suggest that *riba* is acceptable without any qualification.

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160 So far inflation is concerned, Islam unequivocally stresses justice in all measures of value. Hence, inflation, which brings continuous and significant erosion in the real value of money, is not compatible with the Islamic emphasis on balance and equilibrium. However, it was suggested that in the current world-wide inflationary climate, the Islamic imperative of socio-economic justice could be satisfied by indexation, or monetary correction, of all incomes and monetary assets. This proposal was given by Dr. Sultan Abu ‘Ali in a seminar organised by the King Abdul Aziz University, Jeddah in October 1978, and was followed by a heated discussion by a committee of economists and shari‘ah scholars. For a detailed discussion in this regard, see Mohammad Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah, 1982, pp.145-186.


The critics of this view assert that the verse 130 of the chapter 3 in al-Qur’an is the first stage of the prohibition of riba, and that the term ‘ad’afan muda’afatan’ (doubling and redoubling i.e., compound) mentioned in the verse is only explaining what the Arabs practiced, not that riba charged would be lawful if the amount were not doubled. Moreover, in their view, the last riba-related verses available in the chapter 2 (275-8) have clearly indicated that any increase over and above the principal should be riba, and as such it is unlawful. In this opinion, the later revealed verse override the previous verse. This applies to all kinds of riba – simple, compound, fixed or variable. This view is also confirmed by an authentic hadith reported by al-Tabari and other expounders of the Qur’anic Exegesis where the Prophet says:

“God has decreed that there should be no riba; and each and every riba (Kullu riban) that was in period of Jahiliyyah (pre-Islamic) is under my two feet and I am making a beginning by remitting the amount of riba that my uncle Abbas has to receive.”

C. Interest Versus Usury

Another controversy on riba is due to the Qur’anic injunctions against riba whether it is ‘interest’, or ‘usury’. Modernists asserted that the riba which is prohibited, and on which there is consensus of opinion, is ‘interest’ when it equals the principal or more; but not ‘usury’. The different interpretations of this divine prohibition is traceable to the time

165 See A.S. Hornby, Oxford Advanced Learner’s Dictionary, New York, 2000. p.1433. It defines ‘Usury’ as ‘the practice of lending money to people at unfairly high rate of interest’. So, an excessive rate especially above the rate fixed by the Government is a usurious rate of interest.
of `Umar Ibn al-Khattab in the first century of the Islamic period, who was quoted as saying:

"The last to be revealed was the verse of usury and the Prophet expired without having made a clear pronouncement on the question of usury. Therefore, give up usury and anything resembling it".¹⁶⁶

It should be noted that in this translation the word 'usury' is used rather than 'interest', though it is not clear whether `Umar, by saying this, did mean 'usury' or 'interest' by riba. However, some modern English commentators of al-Qur`an, like Muhammad Asad,¹⁶⁷ have used the term 'usury' for riba. This interpretation comes close to the argument that a modern capitalist would make in favour of charging a positive rate of interest on a business loan under uncertainty with varying degrees of risk. Abdullah Yusuf Ali, who also translates riba as 'usury' in his brilliant English translation and commentary on the Qur`an, gives the most clear-cut case in favour of interest within the structure of modern credit and banking systems. He states:

"The definition I would accept would be: undue profit made, not in the way of legitimate trade, out of loans of gold and silver, and necessary articles of food, such as wheat, barley, dates, and salt (according to the list mentioned by the Holy Apostle himself). My definition would include profiteering of all kinds, but exclude economic credit, the creature of modern banking and finance".¹⁶⁸

This position, however, is rejected by several modern writers, like Mawdudi,¹⁶⁹ on the subject of riba. These writers generally interpret riba to mean 'interest' rather than

‘usury’. They also argue that neither in Judaism nor in Christianity, had the distinction between the two terms - ‘interest’ and ‘usury’ - been recognised, let alone accommodated, until the Renaissance in Europe. In Islam also there is no room for arguing that riba refers to ‘usury’ and not ‘interest’, because the nature of its prohibition is strict, absolute and unambiguous. In additions, they refer to several hadiths in support of their view that the Prophet prohibited the taking of even a small gift, service or favour as a condition for the loan, in addition to the principal. Defending `Umar’s interpretation of riba they say that his words can, by no means, be interpreted to have narrowed down the prohibition of riba where his utterance “give up usury and anything resembling it” is in conformity with another saying of the Prophet “Leave what is doubtful in favour of what is not doubtful.” The degree of care in such circumstances, as they say, is more enhanced especially in face of the grave nature of riba, which is condemned outright by the Prophet. They rejected Abdullah Yusuf Ali’s definition arguing that al-Qur’an does describe one form of riba as undue increase, but riba was never defined as undue profit, neither in al-Qur’an, nor by the Prophet. According to their view, riba includes any material benefit above the capital sum lent, which a lender may derive from a borrower. Banks do not lend money for blessings, nor do they charge interest for the purpose of recovering losses sustained through inflation. They do it for profit. So, “economic credit,
the creature of modern banking and finance” as they claim, is most definitely *riba*, regardless of whether the interest-rate is high or low or compound or simple. Thus, according to these writers, any attempt to differentiate between ‘interest’ and ‘usury’ in order to allow the former is an alien concept to *shari’ah*.

**D. Consumption Loans Versus Loans for Business Investment**

Some modernists tend to differentiate between ‘consumption loans’ and ‘investment loans’, and argue that *riba* on consumption loans is unlawful, but it is lawful on investment or production loans. The basis of the Qur’anic injunctions against *riba*, as they claim, is that those who borrow are assumed to be in need of such loans for purposes of maintaining some minimum standard of living. Therefore, *al-Qur’an* intended to prevent the exploitation of the economically weak people of the society, as well as to discourage excessive consumption. On the other hand, in the case of loans for business investment it is argued that the basic reason for the banning of *riba* is that it generates income without labour on the part of the lender. They present some historical records to support this view as saying that in the early years of Islam borrowing for trade or commercial purposes was not practiced, rather sharing and partnership were the only ways to increase the stock of capital. Furthermore, it is argued that seventh century Arabia knew mostly loans for consumption or distress purposes and not productive ventures. Therefore, *riba* charge on business loans is not forbidden in Islam.

On the opposite side of this view, orthodox writers, however, go to some length to disprove this contention. They argue that even if some kind of *riba*-based transactions

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were not practiced at that time when this rule was made, it is still subject to that same rule. To support their view, they reason that when Qur'anic injunction came against *khamr* or alcoholic beverage, many of the drinks which are common today did not exist. Yet everyone agrees that they are still prohibited. In addition, proponents of this view, questioning the historical evidence mentioned by the supporters of the modernists' view, present some other historical evidence to show that commercial loans were indeed common in the early Islamic society.\(^{178}\) In favour of this view, an Egyptian scholar Shaikh Abu Zahrah pointed out that:

"There is absolutely no evidence to support the contention that the *riba* of *al-Jahiliyyah* (pre-Islamic *riba*) was on consumption loans. In fact the loans for which a research scholar finds support in history are production loans. The circumstances of the Arabs, the position of Makkah and the trade of Quraish, all lend support to the assertion that the loans were for production and not consumption purposes."\(^{179}\)

The proponents of this conservative view also claim that in applying the Qur'anic injunctions against *riba* the Prophet himself did not make any distinction between consumption and production loans. Hence, according to this view, the prohibition of *riba* is deemed applicable to both the categories, and it is irrelevant whether it relates to loans for consumption or productive purposes.\(^{180}\)


E. Nominal Versus Real Rate of Interest

Another controversy between modernist and conservative views on riba turns around its interpretation under inflationary and deflationary conditions. Modernists contend that although the Prophet was aware of the effect of inflation,\(^{181}\) there is no hadith on riba that considers the effects of inflation and deflation on loan transactions. In fact, Inflation reduces the real purchasing power of money, whereas deflation increases its purchasing power. Therefore, the proponents of modernists view suggest that in an inflationary economy, an interest rate which will correct the loss suffered by the creditor due to inflation could be justified by allowing an increase or interest to compensate for the loss of purchasing power of money. In support of this view, they argue that by means of the indexation of loans, i.e., by allowing interest up to the ceiling of inflation no real predetermined benefit is allowed to the lenders; rather this simply allows the lenders to retain the real value of their monetary asset intact. Inflation erodes the monetary asset of the lenders for no fault of their own.\(^{182}\) Although Islam urges justice to the borrowers it does not approve of injustice to the lenders. Inflation undoubtedly does injustice to the riba-free lenders by eroding the real value of Benevolent Loan – a loan extended without either interest or profit sharing.\(^{183}\) The outright prohibition of nominal interest indeed increase to cater for inflation would act as a disincentive to lend money which will have negative economic ramifications. So, it has been suggested that suitable interest and discount rate be devised to neutralise the effects of rising and falling prices.


\(^{182}\) Huq, M. Azizul, “Prohibition of Interest and Some Common Misgivings”, in Ataul Hoque (ed.), *op.cit.*, pp.45-46.

The opponents of this view have, however, dismissed the arguments they set out on several grounds, maintaining that all kinds of increase related to loans transactions irrespective of nominal or real rate of interest, would be contrary to the Qur’anic injunctions against riba, and must be accepted as they stand. It is argued that the use of interest to neutralise inflation would tantamount to using a bigger ‘evil’ to fight a smaller one, and Islam does not encourage the introduction of new ‘evils’ to fight existing ones.\textsuperscript{184} The general verdict of the Muslim jurists has so far been against indexation of loans as it involves an assured positive return on loans even though it is only in monetary, and not real terms.\textsuperscript{185} Hence, the question of nominal or real rate of interest does not arise; rather being riba any increase or interest should be considered unlawful. Moreover, the best conformity to the norm of socio-economic justice emphasised by Islam is price stability and not indexation of loans and assets.

F. Compound Versus Simple Interest

The proponents of modernists view towards riba say that its prohibition applies to compound and not to simple interest. In support of their argument they put forward the Qur’anic verse wherein it has been enjoined upon the believer not to devour usury, doubling and quadrupling. Besides other contention the opponents refer them to the Qur’anic verse which was revealed after the verse referred to by the modernists and which contains the words “And if you repent, then you have your principal (without interest).” This verse clearly states that no more than principal is allowed to the creditor, which is further supported by the Prophet’s declaration in his sermon on the occasion of the

\textsuperscript{184} Huq, M. Azizul, "Prohibition of Interest and Some Common Misgivings", in Ataul Hoque (ed.), \textit{op.cit.}, p.46.

\textsuperscript{185} Chapra, Umer M., \textit{Towards a Just Monetary System}, \textit{op.cit.}, p.40.
Farewell pilgrimage; “All riba is abolished, but you have your capital, wrong not and you shall not be wronged”. They contend that the same words “Wrong not and you shall not be wronged” appeared first in the Qur’anic verse (2:279) and then repeated in Prophet’s saying to point out that neither would the debtor be tyrannised over by being compelled to pay anything in addition to the principal nor the creditor suffers a loss in his or her principal. Thus, no question of simple or compound interest can arise.

G. Individuals Versus Institutions

Some modernists contend that the larger financial institutions like banks and other institutions as exist today were not available at the time of the Prophet and hence bank interest and other institutional interest does not cover the prohibition of riba, the prohibition does cover only individuals. It is also viewed that taking riba by an individual from such institutions should not be prohibited because an individual cannot exploit a larger organisation like a bank, as they claim. As opposed to this view, it has been argued that if a modern bank is compared with individuals it is found as an institution, which borrows to lend. Thus, banks are institutions act as borrowers and lenders of funds, and in the process of borrowing and lending they receive and pay riba. The Qur’anic prohibition of riba is general in nature having universal application as it does not make any distinction between an institution and an individual in this regard. So, giving and taking riba by individuals or institutions fall under the same Qur’anic injunctions without any exemption. Furthermore, business institutions in present form though not necessarily were prevalent at that time, some of these business

houses used to practice *riba* as a part of their business. The prohibition of *riba* was applied to them as well.

In spite of these varying opinions, the modernists so far have failed to have much impact on contemporary debate on *riba*. Their views towards prohibition of *riba* have been met by some neo-revivalist critics, like Sayyid Qutb\(^{189}\) and Mawdudi\(^{190}\) with both economic and scriptural counter arguments, and their position has been undermined as they could not present a consistent theory of *riba* on the basis of the rationale of prohibition specified in *al-Qur’an*. Furthermore, the global rise of Islamic banking institutions inspired by neo-revivalist thinking on the issue of *riba*, which views that ‘any interest is *riba*, and as such is prohibited.’

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\(^{189}\) For a survey of arguments on interest see, Sayyid Qutb, *Tafsir Ayat al-Riba*, op.cit., also *Fi Zilal al-Qur’an*, op.cit.

Chapter VI

ISLAMIC BANKING: THEORY AND PRACTICE
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6.1 Islamic Banking in Theory: A Literature Survey

Islam provides a complete code of life from the cradle to grave, as such its laws and teachings are much more detailed and specific, which affect aspects of an individual’s social, spiritual and private life. In line with Islamic teachings, Islamic scholars put a great emphasis on the attention of Islam to material prosperity and economic progress.\textsuperscript{191} The Muslim scholars always paid very strong attention to the issue of the Islamic socio-economic system. In the 1960’s and 1970’s, research intensified and specialisation emerged in different fields, and among this specialisation, the economic system of Islam has received the most attention. There are currently two major research centers in the Muslim world for the study of the Islamic economic system, one in Pakistan and another in the Kingdom of Saudi Arabia. Earlier works were mostly written by authors who seem to have had a strong background in religion but very limited knowledge of Islamic banking, gradually several researchers having formal training on this subject showed their keen interest on the subject, and in recent years many technical papers have been published. In 1976, M. Nejatullah Siddiqi published an extensive review of literature on Islamic economic thought. His work is the most detailed review published on the topic so far.\textsuperscript{192} Another book, “Banking Without Interest” written by the same author is so far the first complete work published on the subject. An eminent Pakistani scholar Khurshid Ahmad comments on the book: “Although a number of scholars have written on this

\textsuperscript{191} See, Muhammad Nejatullah Siddiqi, \textit{Banking Without Interest}, op.cit.; M. Umar Chapra, \textit{Towards a Just Monetary System}, op.cit.

subject during the last fifty years or so, it is no exaggeration to say that Dr. Siddiqi’s book: *Ghair Sudi Bankari* (Banking Without Interest), which appeared first in Urdu in 1969, contained a full treatment on the subject for the first time.\textsuperscript{193}

The theory of Islamic banking is based essentially on the principle that *riba* is neither a necessary nor a desirable basis for the conduct of banking operations and that the *shari‘ah* provides a better alternative to organise the working of banks. The practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions.\textsuperscript{194} However, the Christian Church gradually changed its doctrine on the subject of interest. On the contrary, among the followers of Islam the institution of *riba* has always been regarded as highly immoral because *al-Qur‘an* strictly prohibits it. Although this prohibition was strictly observed by them in the early history of Islam but with the decline of the hold of religion, financial practices based on *riba* began to permeate the Muslim societies as well. Muslim scholars argue that in the period of colonial domination of Muslim countries by Western powers, the *riba*-based system became solidly embedded, which has led to the present-day dominance of interest in financial transactions all over the world.\textsuperscript{195}

The basic postulate that has guided all theoretical works of Muslim economists and scholars on Islamic banking is the Qur‘anic verse (2:275) which says that God has permitted trade and forbidden *riba*. Conventional banking uses the interest rate mechanism to act as financial intermediary between savers and investors. Muslim scholars have developed a radically different model of banking which does not make use of interest and relies instead on profit and loss sharing (PLS) to perform its task of financial

\textsuperscript{193} Siddiqi, Muhammad Nejatullah, *Banking Without Interest*, op.cit., p.8.


\textsuperscript{195} Ibid., p.13.
intermediation. The earliest references to such model are available in their writings in the late forties and early and mid-fifties of the last century, while the sixties and seventies witnessed more elaborate formulations of the concept of Islamic interest free banking. The subsequent period has seen further refinements in the theory of Islamic banking. A brief literature survey on the theory of Islamic banking follows as under.

A. Concepts and Models of Islamic Banking

The theoretical work on the concept of Islamic banking has proceeded on the basis that guidance for all institutionalised developments in an Islamic society should be derived from the principles of shari’ah. Scholars in search of a new form of interest free banking noted that though banks did not exist in the early Islamic period, the practice of financial resources of the parties involved in the conduct of trade or industry was fairly widespread. Islam prohibited all interest based transactions and allowed the continuance of the system of profit and loss sharing that were being practiced in the pre-Islamic period. The two forms of profit and loss sharing, which were predominantly in use at that time, are known as musharakah and mudarabah. Muslim jurists of early Islamic period closely examined the features of these two forms of financial arrangement and built a corpus of juridical opinion to make them fully compatible with the ethos of the value system of Islam.

In developing models of Islamic banking and finding practical solutions to modern day problems, scholars of recent times have departed from some of the opinions of the fuqaha' of early Islamic period in matters on which al-Qur'an and sunnah provide no specific injunctions. The hard core of almost all the Islamic banking models developed so far is a two-tier mudarabah contract. The earliest contributions on the subject were of the nature of summary proposals and had very few details. With the passage of time, increased
attention has been given to the details of the operating procedures of Islamic banking, imparting greater degree of realism to the theoretical models. The shari'ah experts associated with the working of a number of Islamic banks which had started operating in the seventies in different countries saw no objection to banks engaging in activities like murabahah, bai' muajjal, ijarah, ijarah wa iqtina and bai' salam.

As no return is allowed on loans and advances in the Islamic system a prominent feature of Islamic banking models is their relegation to a very minor role whereas they play a dominant role in the assets structure of the interest based banks. The use of lending is confined mainly to help meet the needs of those who are unable to secure financing facility in any other way.

The literature on Islamic banking also deals with the philosophy of Islamic banking. It has been pointed out that the monetary and banking system of a country is an integral part of its parent ideology. Given this perspective, the riba-free modes of financing have to be chosen over the riba-based ones keeping in view the religious orientation of an Islamic society. Also, the financing activities of Islamic banks have to be directed towards achieving the Islamic socioeconomic objectives of eradication of poverty, achievement of an equitable pattern of income distribution and generation of maximum employment opportunities. It has been argued that these objectives can best be achieved through Profit and Loss Sharing (PLS) techniques of mudarabah and musharakah.

The literature on Islamic banking also discusses the roles and responsibilities of the central bank in an Islamic economy. It has been emphasised that the central bank would

196 It is not intended to survey here the various individual contributions in the field. A good survey of such contributions is available in Muhammad Nejatullah Siddiqi, Muslim Economic Thinking: A Survey of Contemporary Literature, Leicester, 1983.

have to play a leading role in the development of new financial instruments for the money and capital markets such as Participation Term Certificates, Specific Investment Certificates, leasing Certificates etc. so as to develop a secondary market in which these types of primary securities will be sold and resold before maturity, imparting liquidity to such securities and widening the choice of investment media available to savers. ¹⁹⁸ Muslim writers have emphasised that the central bank should make a skillful use of monetary policy instruments available to it to influence the operations of the banking system so that the egalitarian objectives of an Islamic society are achieved with greater ease.

B. Feasibility of Islamic Banking

A good part of the literature on Islamic banking is concerned with the feasibility of interest free Islamic banking. A good deal of misgivings has been expressed about its viability, the more important of which can be stated as follows.

1. Because of commitment to share in losses also, Islamic banks working on the principle of PLS will be exposed to huge losses leading to their failure and insolvency,

2. Islamic banks will experience frequent defaults and loss in their earnings on account of concealment of correct income by their clients which will undermine their stability, and

3. Islamic banks cannot perform all the banking functions on non-interest basis in a world, which is dominated by interest-based transactions.

However, Muslim scholars tried to dispel these misgivings and have pointed out that the commitment of Islamic banks to share in losses will not necessarily involve them in huge losses leading to their failure and insolvency. They are expected to operate on the basis of a diversified investment portfolio to maintain the overall profitability of the banks. The nature of the party to whom finance is provided, the purpose for which finance is provided and the type of supervision exercised by the banks on the end-use of funds – these are the main elements which are germane to the possibility of defaults, and are essentially the same for an Islamic bank and a conventional bank. If sufficient care is not exercised in regard to these elements, defaults would arise irrespective of whether the bank concerned practices *riba* or principles of Islamic banking, and there is no reason to believe that the Islamic banks would be exposed to greater losses as compared to other banks.

In reply to the misgiving about the feasibility of Islamic banks that they cannot perform all the banking functions on non-interest basis in a world dominated by interest Muslim scholars recognise that successful conduct of Islamic banking in an international environment, which is permeated with interest, is of course a big challenge. Given the necessity of Islamic banks to deal with conventional banks on non-interest basis, in a number of contributions it has been suggested that the following procedure could be adopted in this regard.
I. The Islamic banks will keep a reasonable amount of cash in their current account with the correspondent banks.

II. The Islamic banks will endeavour to correct a debit balance in their account with correspondent banks as soon as possible.

III. The correspondent bank will not charge any interest on the temporary debit balances of Islamic banks in lieu of its freedom to use the credit balances of Islamic banks profitably without paying any compensation to the Islamic banks, and

IV. As partial security, the correspondent bank, while adding its confirmation to import letters of credit, will debit the Islamic banks only with a certain "cash margin" so that Islamic banks need to keep only such credit balances with correspondent banks as are likely to cover the cash margins of the letters of credit and not the whole value of these letters.199

C. Socioeconomic Consequences of Islamic Banking

The possible socioeconomic consequences of Islamic banking have been the subject matter of extended discussion in recent literature mainly on the basis of presumption that PLS modes of financing of Islamic banking will have a dominant role while the other modes would be used sparingly. The major focus of discussion has been on the possible impact of Islamic banking on the following specific areas.

1. Impact on Saving and Investment

Concerns have been expressed in the literature on Islamic banking that adoption of an interest free system may have an adverse effect on saving because of increased uncertainty in the rate of return. Muslim economists have argued that the actual income would depend on a number of factors such as the form of utility function and its risk properties, for example, the degree and the extent of risk aversion, the degree to which future is discounted, whether or not increased risk is compensated by higher return, and finally the income and substitution effects of increased uncertainty. It has further been argued that the move to an Islamic interest free system, under certain conditions, could lead to increased rates of return on savings. Consequently, the increased level of uncertainty that could result from adoption of PLS based system could be compensated for by an increased rate of return on savings, leaving the overall level of savings unchanged or perhaps even leading to an increase in savings.

As regard to the possible impact of Islamic banking on the level of investment, Muslim economists pointed out that both the demand for investment funds and the supply of investment funds are likely to show an increase consequent to replacement of interest based banking by PLS based banking. The demand for investment funds is likely to increase, as a fixed cost of capital is no longer required to be met as a part of the firm’s profit calculations. The marginal product of capital can, therefore, be taken up to the point where maximum profits are obtained without the constraint of meeting a fixed cost of capital. The supply of investment funds is likely to increase as PLS based bank are enable

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201 See, Zubair Iqbal, and Abbas Mirakhor, Islamic Banking, op.cit., p.p.5.
to undertake the financing of a larger number of risky projects on account of an enhanced risk absorbing capacity.203

2. Impact on the Rate and Pattern of Growth

Several scholars have pointed out that the expected favourable impact of PLS based banking on the level of investment would impart a distinct growth orientation to the economy.204 The increased availability of risk capital under the Islamic system would promote technological innovation and experimentation, which would be another plus factor for growth. Islamic banks are also expected to influence the pattern of growth through appropriate selectivity in their financial operations to ensure that the process of growth is broad based and an optimal use of bank resources is made for purposes, which rank high in Islamic socioeconomic objectives.

3. Impact on Allocative Efficiency

Allocative efficiency of a financial system based on an Islamic framework of profit sharing has been an area of major concern in the literatures of many Muslim economists.205 It has been pointed out that Islamic banking would be more efficient in allocating resources as compared to the conventional interest based system. This position is defended on the basis of the general proposition that any financial development that

203 For some important contributions on the subject, see the study by Nadim Ul Haque and Abbas Mirakhor mentioned in the preceding note and also M. Umer Chapra, *Towards a Just Monetary System*, op.cit., pp.111-117, and M. Nejatullah Siddigi, *Issues in Islamic Banking*, op.cit., pp.88-89.
causes investment alternatives to be compared to one another, strictly based on their productivity and rates of return, is bound to produce allocative improvements, and such a proposition is the cornerstone of the Islamic financial system. Muslim scholars emphasised in their writings that non-existence of interest does not mean that discounting as a technique of computing the present value of future cash flows cannot be used in an interest free economy. It has further been pointed out that interest rate is not the proper discount factor under conditions of uncertainty even in interest based economies. Under conditions of uncertainty, the rate of return on equity is the proper discount rate. Since the real world is a world of uncertainty, and no real investment in any economy can be undertaken without facing risks, cash flows of such investment should be discounted not by a riskless interest rate but by the true opportunity cost of venture capital. 206


It has been argued in the writings on Islamic banking by some writers that a switch over from interest based banking to PLS based banking would impart greater stability to the banking system. In the interest based system, the nominal value of deposit liabilities is fixed and no assurance that all the loans and advances will be recovered. Shocks on the assets side, therefore, lead to divergence between assets and liabilities, and the banking system can suffer a loss of confidence in the process, leading to banking crises. On the other hand, in the PLS based system, the nominal value of investment deposits is not guaranteed, and shocks to the assets positions are promptly absorbed in the values of

investment deposits. This minimises the risk of bank failures and enhances the stability of
the banking system.\textsuperscript{207}


Muslim scholars in their literature on Islamic banking have taken note of apprehensions
expressed in certain circles that replacement of interest by PLS may make the whole
economic system highly unstable as disturbances originating in one part of the economy
will be transmitted to the rest of the economy.\textsuperscript{208} Such apprehensions are viewed by them
to be lacking in substance and they suggest, on the contrary, that elimination of interest,
coupled with other institutional features of an Islamic economy, will tend to enhance
stability. It has been pointed out that interest based debt financing is a major factor in
causing economic instability in capitalist economies. When the interest-based banks for
example, find the business for what they sanctioned loans are beginning to incur losses,
they reduce assistance and call back loans, which results in closing down that business.
This increases unemployment, which leads to further reduction in demand, and the
infection spreads. Islamic banks, on the other hand, are prepared to share in losses, which
reduces the severity of business recession and enables the productive enterprises to tide
over difficult periods without a shut down. Islamic banking has, therefore, to be regarded
as a promoter of stability rather than instability.\textsuperscript{209}

\textsuperscript{207} See Mohsin, S. Khan, "Islamic Interest Free Banking: A Theoretical Analysis", in Mohsin S. Khan and
\textsuperscript{209} See M. Anas Zarqa, "Stability in an Interest-Free Islamic Economy: A Note", \textit{Pakistan Journal of
6.2 Islamic Banking in Practice

Apart from theoretical approaches to Islamic banking, which continued to progress over time, there are now two distinct and parallel approaches in regard to adoption of Islamic banking practices in the Muslim world. In a number of countries Islamic banks have been started on private initiative. The governments of these countries have not committed themselves to the abolition of interest, and Islamic banks exist side by side with interest-based banks. At the state level, two Muslim countries - Iran and Pakistan - are following a different approach aimed at economy wide elimination of interest. In Sudan, where Islamic banks co-existed with interest based banks for a long time, the government has now opted for economy wide Islamisation of banking. The following section of this study reviews the development of these competing approaches to Islamic banking in practice.

The first modern attempt to establish an Islamic banking on individual initiative was in Malaysia in the mid-1940s. The objective of this institution was to invest prospective pilgrim savings in real estate and plantations in accordance with shari`ah but it was unsuccessful. After the Malaysian experiment towards the establishment of an Islamic banking institution, another attempt was made in Pakistan in the late 1950’s and a small experimental Islamic bank was established in the rural area. The initial capital was provided by a group of small local landowners who deposited funds in the institution primarily for religious reasons. No interest or profit was paid to these depositors. The bank provided interest-free loans to the poorer landowners for a small administrative charge. Unfortunately, the venture did not survive for long and the bank was closed down after few years of its operation due to the shortage of funds.

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210 Haron, Sudin, Islamic Banking: Rules and Regulations, op.cit., p.3.
211 See Rodney Wilson, Banking and Finance in the Arab Middle East, New York, 1983.
The third individual initiative towards Islamic banking was taken in Egypt in 1963. In this case, a small bank was founded by Ahmad Al-Najjar in Myt Ghamr - a rural town near Cairo. Originally, the bank had about 1,000 depositors but very soon it gained the trust of the conservative local community and the number of depositors grew to more than 60,000 in its three years’ operation. The success of Myt Ghamr savings bank was based on its appeal to the devout Muslim population of these communities. The bank did not charge any interest on loans and did not pay any interest on deposits either. While a portion of loans was borrowed for investment purposes, the bank did not share in the borrowers’ profits. Instead, they only charged a small administrative fee. This bank continued working until 1967 when it was wound up. It ran out of funds because it did not share in the profits as indicated earlier, and it lacked staff.

These three early attempts in Islamic banking were not investment or profit oriented. Their main objective was to provide interest-free loans to the low income and poor individuals. The lack of a clear alternative to the interest charge was the primary reason for their inability to survive beyond a few years. Their shortcomings perhaps were one of the reasons that Islamic scholars proposed profit and loss sharing (PLS) as the basis of Islamic banking.

During the 1970’s, development of Islamic banking took a different direction. Unlike the above-mentioned three savings banks, the new Islamic banks were oriented toward profitable investments. In 1972, Ahmad Al-Najjar, the founder of Myt Ghamr Savings Bank, established a new Islamic bank called Nasser Social Bank. This bank continued to offer many of the services that were offered by the Myt Ghamr Savings Banks in addition to allocating a portion of its resources to direct equity investment. The initial capital of about $2 million was provided by the Egyptian government, which has
remained the sole owner of the bank. The state support has continued and the paid-up capital of the bank is much larger today.\textsuperscript{212}

The progress of the Nasser Social Bank was a major source of encouragement for Islamic banking in other countries. Through continuous motivation Ahmad Al-Najjar managed to establish the Dubai Islamic Bank in 1975, which was financed by a group of merchants in U.A.E. He also convinced Prince Muhammad Bin Faisal of Saudi Arabia to establish the Faisal Islamic Bank of Egypt and the Faisal Islamic Bank of Sudan in 1977, with 40\% of the initial capital of Saudi people for the Faisal Islamic Bank of Sudan and 49\% of the initial capital for the Faisal Islamic Bank of Egypt.\textsuperscript{213} Unlike the Myt Ghamr and Nasser Social Banks, they distributed a portion of their profits among depositors and shifted their lending and investment activities from interest-free assistance loans to profitable equity investment and PLS loans. They offered two basic types of accounts: savings accounts that are fully insured but earn no profits, and investment accounts that share in the profits and losses of the bank. These three banks have been able to survive and compete with conventional banks for depositors. The Dubai Islamic Bank has become the largest national Islamic bank with $13 million in paid up capital and nearly $100 million in deposits in 1980.\textsuperscript{214}

Ever since 1975, new Islamic banks and financial institutions similar to the Dubai Islamic bank have been established in almost every part of the Muslim world in particular, and rest of the world in general;\textsuperscript{215} and their presence has been accepted by the financial

\textsuperscript{213} See Rodney Wilson, \textit{Banking and Finance in the Arab Middle-East}, op.cit., pp.85-88.
\textsuperscript{214} Ibid, p.88.
\textsuperscript{215} See I.AIB (The International Association of Islamic Banks), \textit{Directory of Islamic Banks and Financial Institutions}, op.cit.
communities of these nations. Several Muslim countries have undertaken steps toward the introduction of Islamic bank.

Beyond establishing and running independent Islamic banks at the state and individual levels, two international Islamic banks namely the Islamic Development Bank (IDB) and Dar Al-Maal Al-Islami (Islamic House of Funds) were established by Saudi initiative during the 1970's and 1980's. The IDB was established in 1975 by the approval of the 38 member countries of the Organisation of Islamic Conferences (OIC). The main objective of this bank was to provide financial capital for industrial and agricultural projects in Islamic nations, and to promote international trade among them. The activities of the bank are limited to mechanisms that are allowed in shari‘ah, particularly musharakah (equity participation) and qard hasan (interest-free loan). The original capital for IDB was provided by several oil-exporting Muslim countries – Saudi Arabia, United Arab Emirates, Kuwait and Libya. During the first five years of operation, IDB had more than $1.5 billion in paid-up capital and financed many development and trade projects throughout the Muslim world.216 Other activities of the IDB included investment in national Islamic banks and equity projects in many Islamic nations. Leasing out industrial machinery was another scheme used by the IDB. Besides providing financial assistance to member countries wishing to establish and promote Islamic banks on their own, it also provides help in conducting and accelerating research in the area of Islamic banking and finance. Overall, the Islamic Development Bank played a significant role in popularising Islamic banking and providing assistance to member countries, particularly to low-income Islamic nations.

216 IDB (Islamic Development Bank), Jeddah, Fourth Annual Report, 1979, p.34.
Dar Al-Maal Al-Islami (DMI) is the second international Islamic bank that was established in 1981. The stated objective of the bank was to support development projects in non-Arab Muslim countries. Though most of the depositors and shareholders were from the oil-rich Arab nations, DMI has tried to reduce its dependency on them by opening branches in other Muslim countries. The performance of the bank during the 1984-85 financial year, in particular, was impressive. To achieve further diversification, DMI targeted the Muslim nations of Africa and Southeast Asia for future investment. Besides the IDB and DMI, there are several smaller international banks some of whose headquartered are located in European capitals, particularly London and Geneva. They were primarily involved in equity investment in European countries.

Overall, there are about 300 Islamic banking and financial institutions in the form of Islamic commercial banks, Islamic investment companies, Islamic national and international holding companies, Takaful or Islamic insurance companies and Islamic development companies which are operating in various Muslim and non-Muslim countries. Some of the Islamic financial institutions are very modest in size; others are larger, while some others are giants. For example, in 1987, Falah Investment Limited, Bombay (India) was operating with a capital of US $ 50 thousand. In the same year, the

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218 The number of countries where these institutions are functioning are: Afghanistan, Albania, Algeria, Argentina, Australia, the Bahamas, Bahrain, Bangladesh, Brunei, the Cayman Islands, Cyprus, Denmark, Djibouti, Egypt, Germany, guinea, Gambia, India, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kibris, Turkish Republic, Kuwait, Lebanon, Liechtenstein, Luxembourg, Malaysia, Mauritania, Morocco, Niger, Pakistan, Palestine, Philippines, Qatar, Russia, Saudi Arabia, Senegal, South Africa, the Sudan, Switzerland, Thailand, Tunisia, Turkey, the United Arab Emirates, the United Kingdom, the United States of America and Yemen. For detailed information on Islamic banks and financial institutions around the world see, Appendix 1.
capital of International Islamic Bank of Denmark was $500 million, while Saudi based Al-Rajhi financial network had capital of seven billion dollars.\textsuperscript{219}

Several Islamic countries have undertaken steps toward the introduction of Islamic banking. Apart from Pakistan, Iran and Sudan, special enactments and suitable changes in banking legislation have also been introduced in Malaysia, Turkey and the United Arab Emirates to facilitate operations of Islamic financial institutions on a national scale. However, these changes are not intended confer any under advantages on these Islamic banks vis-à-vis the conventional banks. They are in fact designed to remove some of the handicaps from which Islamic banks suffer in conducting their operations in an economy where interest based transactions dominate the scene. By employing funds in ways that avoid \textit{riba} and by performing most of the conventional banking services, these institutions have successfully established the practicality and viability of Islamic banking. In fact, the rapid growth of Islamic banks has been not only in terms of number, but also in terms of the volume of their assets.

In addition to the above-mentioned Islamic banking experiences, some interesting experiments have been made of what may well be called institutionalised use of Islamic modes of deposit mobilisation and financing, if not full-fledged Islamic banking, in quite a few non-Muslim countries. Besides, there are a number of non-Islamic financial institutions in non-Muslim countries, which offer Islamic financial services for their Muslim clients.\textsuperscript{220} Apart from this, some Muslim countries have given permission to conventional banks to open “Islamic banking windows” in order to fulfill the strong and persistent demand of the Muslim masses for Islamic banking services. There is a good deal

\textsuperscript{219} Anwar, Muhammad, \textit{Modelling Interest-Free Economy: A Study in Macro-economics and Development}, op.cit., p.10.

\textsuperscript{220} Among these are such well-known institutions as Kleinworth Benson Which offers an Islamic Unit Trust, and the Union Bank of Switzerland and Lander bank of Vienna which offer Islamic investment funds.
of controversy, however, about the financial services being offered by such institutions being in full conformity with shari‘ah requirements.\textsuperscript{221}

To conclude, it can be said that Islamic banking is now a reality and not just a theoretical response to the issue of riba. The existence of Islamic banking institution clearly demonstrates that there is an alternative to conventional ‘interest-based’ banking. Moreover, the phenomenon of Islamic banking has enriched the financial law and economic literature, for there have been many works written on the issue of Islamic financial theory. The following comment adequately describes the situation:

“Islamic banking – as the system is widely known – was first ridiculed in the West as a ‘fundamentalist phenomenon’, then just tolerated. Now, after careful scrutiny, it is being adopted in Western financial institutions and other interest-based commercial banks in the Muslim world. Islamic bankers have survived the credibility crisis and are no longer basking in the glory of divine revelation. With US$15 billion worldwide under their control, they are pragmatic and scientific.” \textsuperscript{222}

6.3 The Objectives and Philosophy of Islamic Banking

The basic objective of Islamic banking, as emphasised in the \textit{Handbook of Islamic Banking} (HIB),\textsuperscript{223} is to provide financial facilities by developing financial instruments that conform with the Islamic rules and norms, shari‘ah. The Handbook mentions: “the

primary goal of Islamic banking is not to maximise the profit as the interest-based banking system does, but rather to render socio-economic benefits to the Muslims." 224

In additions, Islamic banking conforms to philosophical underpinning of Islam. Since God is the creator and ultimate owner of the universe, institutions or human beings have a vicegerency role to play in society. Therefore, banking institutions have to integrate moral values with economic action. Money and other resources are thus social tools to achieve optimum social good and welfare.

In view of the above, the objectives of Islamic banking are to promote, foster and develop the application of Islamic principles, law and tradition to the transaction of financial, banking and related business affairs services and to promote products based on Islamic principles. 225 As discussed earlier in this study, Islam is a complete code of life and as such prescribes the manner in which all actions of a Muslim ought to be conducted. Therefore, conducting worldly affairs, including banking, in the manner prescribed by shari‘ah is an obligation of a Muslim is viewed as an act of worship.

These objectives have truly reflected in the functions of Islamic bank as determined by the International Association of Islamic Banks (IAIB) in the following few sentences:

“The Islamic Bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic shari‘ah in the fields of finance and other dealings. Moreover, the Bank functioning in this way must reflect Islamic principles in real life. The Bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious spirit among the people.” 226

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224 Ibid., pp.153-55.

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The objectives and philosophies of Islamic banking are thus in line with the revelations in *al-Qur'an* and the *hadith*, and it is expected to be guided by these philosophies. Establishing the right philosophies is important for any Islamic banking or financial institution mainly for two reasons.

**Firstly**, these philosophies will be used by the management or policy makers of Islamic banks in the process of formulating corporate objectives and policies.

**Secondly**, these philosophies serve as an indicator as to whether a particular Islamic bank is upholding true Islamic principles or not. In this connection, it needs to be emphasised that while the *riba* is prohibited in Islam, earning or profit on investment in trade and business is permitted and encouraged provided that the related risks and gains are not one-sided but balanced. So, from the religious perspective, the establishment of an Islamic bank is considered to be a righteous move having its involvement in legitimate trade; and for paving the way to perform banking business in line with the *shari'ah*.

Eliminating *riba* in the banking system is an indispensable part of Islamic business principles. Management and staff of this system are bound to conduct their business with conformity to Islamic business principles in addition to the normal objective of profit maximisation. These principles include honesty, justice and equity as ordained by God and practiced by God’s Prophet. In the process of conducting business, Islamic banking seeks to balance between earning and spending with a view to maximise social benefit. It should be emphasised that in Islam earning should be lawful. In terms of spending wealth, it demands its followers to spend for the welfare of the people and not to waste nor use it in illegitimate ways. Islamic banks’ relationship with their clientele is not that of a lender and borrower but that of a business partner. Several Muslim scholars have emphasised the
point that since Islamic banks are committed to work on the basis of a completely different philosophy, they should have a pronounced orientation towards channeling resources to poorer sections of society so as to improve their economic well being in line with the Islamic socio-economic objectives.\(^{227}\)

It may be argued that some of the objectives and functions of Islamic banking system, as stated above, are the same as those under conventional banking system. Though there may be an apparent similarity, there is in fact a significant difference in emphasis, arising from the divergence in the commitment of the two systems to spiritual values, socio-economic justice and human brotherhood as the goals and objectives in Islam are inviolable part of the ideology and the faith.

6.4 The Problems and Challenges Faced by Islamic Banking

Though there are many operational and other problems specific to Islamic banking in different countries, the emphasis is mainly given here on the general problems faced by this sector, under the following major headings.

1. Unfamiliarity with the Islamic Banking System

Despite the growth of Islamic banks over the last 30 years, many people in the Muslim and non-Muslim world do not understand what Islamic banking actually is. The basic principle is clear, that it is contrary to Islamic law to make money out of money and

that wealth should accumulate from trade and ownership of real assets. However, there does not appear to be a single definition of what is or not an Islamic-banking product; or there is not a single definition of Islamic banking. A major issue here is that it is the shari’ah Councils or Boards at individual Islamic banks that actually define what is and what is not Islamic banking, and what is, and what is not the acceptable way to do business, which in turn can complicate assessment of risk for both the bank and its customer. More generally, the uncertainty over what is, or not, an Islamic product has so far prevented standardisation. This is difficult for regulators understandably they like to know exactly what it is they are authorising. It is also an added burden on the banks that have to educate customers in new markets.

2. Mobilisation of Funds

The rise in oil prices in the early seventies in the oil-producing Muslim countries as well as development in the commercial, industrial and agricultural sectors in non-oil-producing countries resulted in the creation of a class of rich people in the Muslim world. But unfortunately the great reserve of Muslim wealth were concentrated in a few hands; those of the ruling elite, politicians, industrialists and businessmen. It is true that the greatest challenge to the development of Islamic banking come from the inertia of a section of rich Muslims who could have played a major role in promoting this sector. Their vast financial resources are not placed in Islamic banks but in conventional banks in a plea that Islamic banks have not, as yet, developed to an extent where they can handle large projects and the substantial investments must therefore, go to conventional banks. In saying this, they do

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228 Ainley, Michael, “Under a Veil of Regulation”, *The Banker*, No. 147, October 1997, pp. 73-74.
not take into consideration that financial organisations cannot develop unless the community supports them or they are supported by at least a substantial group of the rich people. Another possible reason why rich Muslims are not supporting Islamic banks may be that conventional banks having been well established for centuries, seems to them safer and certainly guarantees a predetermined return with little or no risk to capital. As long as the rich Muslims do not place their funds in Islamic banks, they will not be able to meet the expectations that were raised at the time of their launching.230

3. Portfolio Management

The behaviour of economic agents in any country is determined partly by past experience and present constraints. The Islamic banks are still growing in experience in many countries. Regarding constraints, Islamic banks in different countries do not freely choose arrangements, which best suits, their interests. As a result, their activities are not demand-oriented and do not react flexibly to structural shifts in the economic setting as well as to changes in preferences. Islamic banks’ management knows that a certain portion of the short-term fund is normally not withdrawn at maturity; these funds could be used for medium or long-term financing, and as a consequence the average maturity on the asset side of balance sheet is longer than on the liabilities side. However, a precondition for this maturity transformation is that the bank be able to obtain liquidity from external sources in case of unexpected withdrawals. Islamic banks, without having an interest-free Islamic money and capital market, have no adequate instruments to meet this pre-condition for effective maturity transformation.231 On the other hand, Islamic banks can enhance term

230 Ibid., p. 15.
transformation if there is an interest-free bank market or a secondary market for Islamic financial papers. Adequate financial mechanism still has to be developed, without which financial intermediation, especially the risk and maturity transformation, is not performed properly.

4. Inadequate Staff

Islamic banks do not have a high degree of expertise in the evaluation of projects. This inability to evaluate the profitability of projects may tend to militate against profitable projects. Islamic banks relied initially on staffs that were trained in traditional commercial banks. They need to be given intensive courses in the workings of shari‘ah, basically explaining the rules, which govern economic activities in Islam. The personnel needed by Islamic banks should not only be well qualified and well versed in the theory and practice of Islamic banking; they should also be committed to the cause of Islam. There is an acute shortage of such personnel and this is adversely affecting the growth potential of Islamic banking.

5. Absence of Liquidity Instruments

Many Islamic banks lack liquidity instruments, such as treasury bills and other marketable securities, which could be utilised either to cover liquidity shortages or to manage excess liquidity.\textsuperscript{232} This problem is aggravated since many Islamic banks work under operational procedures different from those of the central banks; the resulting non-compatibility prevents the central banks from controlling or giving support to Islamic banks if a liquidity

\textsuperscript{232} Ibid., p.113.
gap should occur. So, the issue of liquidity management altogether with matters related to investment and commodities funds, must come under active discussion and scrutiny by the authorities involved in Islamic banking.

6. Shortage of Investment Instruments

One of the major problems facing Islamic banks and financial institutions globally is the shortage of marketable financial instruments. Sadly, the Islamic financial market has reached a stage where its present sets of instruments cannot attract investors. On the contrary, investors in the conventional banks have a wide range of instruments as against Islamic banks, which can offer their clients few acceptable instruments. Besides, there are a large number of other issues relating to Islamic banks that need to be researched. These include:

a. Project finance;

b. Identification of investment opportunities;

c. Trading practice and systems of settlement; and

d. Islamic capital markets.\(^{233}\)

Islamic banks will attract investors only if a wide range of attractive instruments and a whole range of service are available.

7. Risk Analysis and Balance Sheet Management

Another problem for Islamic banking in interest-based financial market is risk analysis and balance sheet management. In a conventional bank interest rate plays a key role in

managing liquidity, pricing risk and allocating credit. In the absence of interest rates, the risk manager in an Islamic bank faces a greater challenge than the risk manager faces in a similar size conventional bank. In addition to this burden, Islamic banks are unlikely to benefit from a critical mass of similar institutions with which an Islamic interbank market can be developed, thus requiring Islamic banks to hold higher levels of liquidity than conventional banks, with a consequent negative impact on their ability to compete.

A related problem is that Islamic banks are excluded from the lender of last resort function in many conventional systems (although we are aware that the Malaysian central bank has introduced an Islamic short-term funding facility). The central bank traditionally stands behind the banking system to offer liquidity, lending to banks if the system is short of funds. Islamic banks may not be able to use this facility because of the interest payments due on the loans. A further difficulty is how to classify risk-sharing funds placed with Islamic banks? Are these funds capital certain? If they are, they would be defined as a bank deposit under the Western banking laws. If, however, they are defined as investments in a collective investment scheme they are not bank deposits. The classification of these funds has implications for Islamic banks’ capital requirements. Thus, Islamic banks’ funding is often on a risk-sharing basis (i.e., if the project incurs a loss then Islamic bank must share the loss as well whereas irrespective of profit or loss of the project the bank must be paid in conventional banking).\(^{234}\)

8. Use of Advanced Technology and Media

Many Islamic banks do not have the diversity of products essential to satisfy the growing needs of their clients. The importance of using proper advanced technology in upgrading

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the acceptability of a product and diversifying its application cannot be overemphasised. Given the potentiality of advanced technology, Islamic banks must have to come to terms with rapid changes in technology, and re-design the management and decision-making structures and, above all, introduce modern technology in its operations within and in relations to its clients. Many Islamic banks also lack the necessary expertise and institutional capacity for Research and Development (R & D) that is not only necessary for the realisation of their full potential, which is enormous, but also for its very survival.235 In this age of fierce competition, sophisticated markets and an informed public, Islamic banking cannot but stagnate and wither without dynamic and ongoing programmes. In addition, Islamic banks have so far ignored the use of media. Even the Muslims are not very much aware that the Islamic banking is being practiced in the world. Islamic banks have not ever used an effective media to publicise their activities.236 The authorities concerned in Islamic banks should address these issues on a priority basis.

9. Need for Professional Bankers

The need for professional bankers or managers for Islamic banks cannot be overemphasised. Some banks are currently run by direct involvement of the owners themselves, or by managers who have not had much exposure to Islamic banking activities, nor are conversant with conventional banking methods.237 Consequently, many Islamic banks are not able to face challenges and stiff competition. There is a need to institute professionalism in banking practice to enhance management capacity by competent

235 Al-Omar, Fuad and Abdel-Haq, Mohammed, Islamic Banking: Theory, Practice and Challenges, op.cit., p.117.
bankers committed to their profession. Because, the professionals working in Islamic banking system have to face bigger challenge, as they must have a better understanding of industry, technology and the management of the business venture they entrust their clients' capital to. They also have to understand the moral and religious implications of their investments with the business ventures. There is also a need for banking professionals to be properly trained in Islamic banking and finance. Most banks' professionals have been trained in secular economics. They lack the requisite vision and conviction about the efficiency of the Islamic banking.238

10. Planning of Future Policies

The planning of future policies is a problem for financial institutions operating in developing economies. This is particularly serious when government policies cannot be predicted with any degree of certainty. Successful planning is dependent largely on information drawn from past experience, matched with adequate knowledge. In view of its short history, Islamic banking is at a disadvantage compared with conventional banking.239 The evaluation of the appropriateness of any financial transaction rests generally on a thorough assessment of alternatives. Hence, a considerable amount of information is necessary. In this regard Islamic banks are expected to exchange information between them and to expand the circle of cooperation with other non-Islamic financial institutions.


11. Social Responsibilities and Developmental Role

Islamic banks should contribute positively to essential social needs, such as poverty alleviation, donating to charities and helping to achieve redistribution of income. They should also put the emphasis on social considerations in training and in their operations, and play a more dynamic role in the achievement of socio-economic growth. Furthermore, it is expected that as Islamic banks become established and profitable, more funds will be diverted and their activities reoriented to fulfill their social responsibilities and developmental role. To enhance their intervention in such areas, the banks should depend more on non-government organisations. This would involve highly motivated workers, operating economically with flexible decision-making that would undoubtedly improve service efficiency.

12. Unification of the Approach of Islamic Scholars with the Approach of the Conventional Bankers

Bankers, due to the nature of their jobs have to be pragmatic or application-oriented. There is and will be tendency in the bankers practicing in Islamic banks to mold or modify the Islamic principles to suit the requirement for transactions at hand. Additionally, being immersed in the travails of day-to-day banking, they find little time or inclination to do any research, which can make any substantial contribution to the Islamic banking. Islamic scholars active in researching Islamic banking and finance, on the other hand, typically have a normative approach, i.e., they are more concerned with what ought to be. A very few of them are knowledgeable about banking or the needs of the customers. 240 This

results in a situation, where both the bankers and scholars suffer from a communication gap. So, there is a need to marry these two disciplines. Both of these need to work together and help in the development of Islamic banking, which is still in evaluation.
Chapter VII

THE ISLAMIC BANKING EXPERIENCES

IN BANGLADESH
THE ISLAMIC BANKING EXPERIENCES IN

BANGLADESH

7.1 General Introduction to the Banking System of Bangladesh

The banking system of Bangladesh was nationalised in 1972\(^{241}\) with the exception of branches of 8 foreign banks. Significant changes have, however, taken place in recent years in the banking system of the country. In keeping with the Government policy of encouraging the private sector to play its due role in the economic development of the country, the Government has allowed setting up of commercial and investment banks in the private sector. In response to the Government policy quite a number of commercial and investment banks have been set up in the private sector and have started functioning. The whole banking system in the country can be classified as nationalised commercial banks (NCBs), private sector banks, specialised banks and development banks. The total number of local and foreign banks that are operating now both in private and public sectors in Bangladesh is 49, out of which only 6 are Islamic and the rest are conventional banks.\(^{242}\) All specialised and development banks are government owned. They are operating in their respective fields to help develop them by providing credit and other services at convenient terms.

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\(^{241}\) With the promulgation of the Bangladesh Bank (Nationalisation) Order 1972, all branches of the then commercial banks of the country were classified under six nationalised commercial banks (NCBs) namely, Sonali Bank, Janata Bank, Agrani Bank, Pubali Bank, Rupali Bank and Uttara Bank. Later, Pubali, Rupali and Uttara Banks have been put in private sector and functioning as private banks with effect from 5th November 1996.

The Islamic banks that have been operating in private sector in the country are: Islami Bank Bangladesh Limited, Al-Baraka Bank Bangladesh Limited, Al-Arafah Islami Bank Limited, Social Investment Bank Limited and Faysal Islamic Bank of Bahrain E.C. The latter i.e., Faysal Islamic Bank of Bahrain E.C., is a foreign bank and is the largest Islamic bank in the world. It opened a branch in Bangladesh in 1998. Beside these Islamic banks, two other private banks, namely the Prime Bank Limited and the Dhaka Bank Limited, have opened two Islamic banking branches and an Islamic banking counter respectively, to deal with the Islamic banking business parallel to their conventional interest-based banking operations since commencement of the banks in 1995. Moreover, at present three Islamic insurance companies namely the Islamic Insurance Bangladesh Limited, Islamic Commercial Insurance Limited and Far East Islamic Life Insurance Company Limited are functioning as Islamic financial institutes in Bangladesh.

Bangladesh Bank is the central bank of the country, which is responsible for promoting growth and development of banking system in the country and for overall control of the activities of all other banks. It has an issue and a banking control department to carry out its objectives, to implement the Government monetary policy and to manage international transactions. Among others, the objectives of the monetary policy are to secure stability in the volume of money and regulate the banking system prudently. As regards the supervision and inspection of the banks, an equal treatment is being followed for all conventional and Islamic banks by Bangladesh Bank. However, considering lack of Islamic financial markets and instruments of products in the country, Bangladesh Bank had granted some preferential provisions for smooth development of

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243 Ibid., p.28.
Islamic banking in Bangladesh. Among these provisions, the following are of great importance.

1. Islamic banks have been allowed to maintain their Statutory Liquidity Requirement (SLR) at 10% of their total deposit liabilities while it is 20% for the conventional banks in Bangladesh. This provision had facilitated the Islamic banks to hold more liquid funds for more investment thereby generate more profit.

2. Under indirect monetary policy regime, Islamic banks were allowed to fix their PLS ratios and mark-ups on their own commensurate with their own policy and banking environment, which had provided scope for them to follow the shari‘ah principles independently for realising goals of shari‘ah.

3. Islamic banks could reimburse 10% of their proportionate administrative cost on a part of their balances held with Bangladesh Bank. This facility has given some scope for enhancement of their profit base.

7.2 Islamic Banking in Bangladesh: A Background

Banking and other financial institutions play very important role in the economy and development of any country. In Bangladesh Muslims constitute almost 88% of its population. People wish to lead their lives as per instructions given in Al-Qur‘an and the sunnah. Bangladesh at its birth in March 1971, inherited an interest-based banking system that was introduced during the British (1957-1947) and Pakistani (1947-1971) rule. Since the conventional banking system is fully based on riba-based transactions and which is absolutely prohibited in Islam, the people of Bangladesh have been looking forward to an alternative to interest-based banking in favour of their normal values and faith. This desire
was specially revived when in the early 1970's there was a successful move to establish the Islamic Development Bank in Jeddah, and Dubai Islamic Bank being the first Islamic Commercial Bank to be followed by a number of other similar institutions in many other Islamic countries. As one of the twenty-six founder members, the Government of Bangladesh signed the Charter of the Islamic Development Bank (IDB) in the Finance Ministers' Conference held at Jeddah in August 1974, and committed itself to reorganise its economic and financial system according to Islamic norms and values. By adopting the above provisions of IDB charters, the subsequent governments also reiterated commitment of Bangladesh to bring its economic, financial and banking activities in line with the *shari`ah*. The implicit undertaking was later explicitly stated in number of international conferences.\(^{244}\) In pursuance to the Government policy and commitment indicated above the following official level actions were taken in respect of the introduction of Islamic banking in the country.\(^{245}\)

1. In November 1979, the Ambassador of Bangladesh in the United Arab Emirates addressed a letter to the Foreign Secretary, Ministry of Foreign Affairs, Bangladesh, recommending establishment of an Islamic bank in Bangladesh in line with Dubai Islamic Bank in the UAE.

2. In December 1979, the Ministry of Finance (Banking and Investment Division), Bangladesh wrote to Bangladesh Bank – the central bank of the country seeking the latter's view on the establishment of an Islamic bank in Bangladesh.

3. In November 1980, Bangladesh Bank deputed its Director of Research, Mr. A. S. M. Fakhrul Ahsan to study the workings of Islamic Banks in the Middle East. After


\(^{245}\) Ibid., pp.39-40.
visiting Dubai Islamic Bank in UAE, Faysal Islamic Bank and Nasser Social Bank in Egypt, as well as the Cairo office of the International Association of Islamic Banks Mr. Ahsan submitted his report to the Government recommending the introduction of Islamic banking in the country.

4. On December 15, 1980, the Governor of Bangladesh Bank recommended early introduction of Islamic banking in the country in an international seminar on Islamic banking held at Dhaka and participated by, among others, the delegates from the IDB and the Saudi Arabian Monetary Agency.

5. In March 1981, the Governor of Bangladesh Bank attended a meeting of Governors of central banks monetary agencies of the member countries of the Organisation of Islamic Conference held in Sudan to consider a report on the promotion, regulation and supervision of Islamic banks.

6. In April 1981, in a letter issued by the Ministry of Finance to Bangladesh Bank advised it to undertake an experiment in the matter of Islamic banking by opening a counter in all branches of the nationalised commercial banks in Bangladesh.

Besides, participation of Bangladesh at an international seminar on “Islam, Banking and Insurance” held at Geneva, deputation of some senior bank executives at an advanced course on Islamic banking in Egypt, as well as holding a month long full day inter-bank residential training course on Islamic banking at Dhaka in June, September and November 1981 respectively - all these contributed towards emergence of Islamic banking in Bangladesh. The Islami Bank Bangladesh Limited (IBBL) with its registered office situated in Dhaka was incorporated as a limited company under the Companies Act 1913 on 13 March 1983. Subsequently, four other Islamic banks have emerged in Bangladesh

246 Ibid., p.41.
in the private sector, which were incorporated as Public Limited Companies under the Bank Company Act 1991.

Currently the following banks are operating as Islamic banks in Bangladesh:

1. Islami Bank Bangladesh Limited

Islami Bank Bangladesh Limited (IBBL) started functioning as a public company with limited liability with effect from 30 March 1983. IBBL is the first interest-free bank established in South East Asia with a broad objective of conducting banking business under Islamic shari'ah.\textsuperscript{247} It is a joint venture of Bangladeshi and overseas capital in the ratio of thirty-six to sixty-four. The Islamic Development Bank, nine other institutions and three individuals of Arab nationality, own its overseas capital, while the Government of Bangladesh, Investment Corporation of Bangladesh, four non-profit private institutions and 19 private individuals own the local capital.\textsuperscript{248} Its shares are quoted in the two stock markets of the country, Dhaka Stock Exchange and Chittagong Stock Exchange. Being in high demand the shares are presently sold at three times higher than the face value. In 2001, IBBL has a paid-up capital of Tk. 320 million and Reserve Fund of Tk. 930.17 million. The Bank has been conducting its operations with 118 branches spread all over the country.\textsuperscript{249}

The Bank is managed by 24-member Board of the Directors elected by the shareholders, an Executive Committee consisting of 9 directors and a Management Committee consisting of the top executives and a representative of the Shari'ah Council. Powers and functions are suitably distributed amongst these bodies. The day-to-day

\textsuperscript{248} Ibid., pp.17-18.
\textsuperscript{249} Ibid., pp.32-34.
management of the Bank is left in the hands of the Executive Committee, while the Management Committee looks after the affairs of the Bank. Apparently, 24-member Board of Directors is a policy making body, as such directors are non-executive directors. IBBL has also a 10-member Shari'ah Council consisting of 11 prominent Islamic scholars and jurists, a banker, a lawyer and an economist. The Council gives opinion on different issues confronting the Bank on Shari'ah matters. They also conduct Shari'ah inspection of branches on selective basis so as to ensure that the Shari'ah principles are implemented and complied with by the branches of the bank.

Table 7.2.1

<table>
<thead>
<tr>
<th>Financial Position of Islami Bank Bangladesh Ltd., 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Established</strong></td>
</tr>
<tr>
<td>August 1983</td>
</tr>
</tbody>
</table>

**Continued**

<table>
<thead>
<tr>
<th>Share-holders</th>
<th>Employees</th>
<th>Foreign Correspondents</th>
<th>Number of Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>7549</td>
<td>2685</td>
<td>775</td>
<td>116</td>
</tr>
</tbody>
</table>


The Bank offers different services.

Investment and trade modes mix of this Bank can be presented through the following pie chart:
2. Al-Baraka Bank Bangladesh Limited

The second Islamic Bank of the country, Al-Baraka Bank Bangladesh Limited (ABB), commenced banking business as a commercial bank with effect from 20th May 1987. This Bank was incorporated on 30 April with registered office in Dhaka. It is a joint venture banking enterprise of Al-Baraka Investment and Development Company of Jeddah, Islamic Development Bank, a group of Bangladeshi entrepreneurs and the Government of Bangladesh. The paid-up capital of the Bank was initially Tk. 150.00 million. To increase the capital, the Bank offered right shares at 1.1 ratios to the shareholders on 1 August 1992. Consequently, the paid-up capital of the Bank now stands at Tk. 259.553 million, which is shared by different groups as under:
1. Al-Baraka Bank Investment & Development Co. Jeddah 34.67%
2. Islamic Development Bank, Jeddah 5.78%
3. Bangladeshi sponsors 45.92%
4. Government of Bangladesh 5.78%
5. General public 7.85%

Total 100%

The Bank has been conducting its operations with 32 branches spread all over the country. The Bank is managed by a 15-member Board of Directors elected by the shareholders, which is its highest policymaking body. The day-to-day affairs of the Bank are managed by an Executive Council consisting of 7 directors. Like IBBL, Al-Baraka Bank has also a Shari‘ah Council which meets frequently and deliberates on different issues confronting the Bank on shari‘ah matters.\textsuperscript{250}

\textbf{Table 7.2.2}

\textbf{Financial Position of Al-Baraka Bank Bangladesh Ltd., 2000}

<table>
<thead>
<tr>
<th>Established</th>
<th>Authorised Capital</th>
<th>Paid-up Capital</th>
<th>Reserves</th>
<th>Deposits</th>
<th>Investments</th>
<th>Foreign Exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>May, 1987</td>
<td>600</td>
<td>259.553</td>
<td>15.9</td>
<td>6401.86</td>
<td>6203.39</td>
<td>3481.79</td>
</tr>
</tbody>
</table>

\textbf{Continued}

<table>
<thead>
<tr>
<th>Share-holders</th>
<th>Employees</th>
<th>Foreign Correspondents</th>
<th>Number of Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>2212</td>
<td>609</td>
<td>108</td>
<td>33</td>
</tr>
</tbody>
</table>

Source: Al-Baraka Bank Bangladesh (ABB) Ltd., Dhaka, \textit{Annual Report 2000}.\textsuperscript{250}

\textsuperscript{250} Al-Baraka Bank Bangladesh (ABB) Limited, Dhaka, \textit{Annual Report 2000}.
3. Al-Arafah Islami Bank Limited

Al-Arafah Islami Bank Limited was incorporated on 18 June 1995, and started its operation as a third Islamic bank in the private sector banking in Bangladesh with effect from 27 September 1995. The Bank is having an authorised capital of Tk. 1000 million and paid-up capital of Tk. 207.60 million. It renders all types of commercial banking services. Al-Arafah Islami Bank is managed by a 23-member Board of Directors. The Bank has a 7-member Shari’ah Council consisting of Islamic jurists, lawyers and Islamic economists. The Council gives advice to the Bank on the operation of its business in order to ensure that the Bank does not involve in any element which is not approved by Islamic shari’ah. By December 2000, the Bank has opened 30 branches all within the country.\textsuperscript{251}

\begin{table}
\centering
\caption{Financial Position of Al-Arafah Islami Bank Ltd., 2000}
\begin{tabular}{|l|l|l|l|l|l|l|}
\hline
 & Established & Authorised & Paid- & Reserves & Deposits & Investments & Foreign & Dep. with other \\
 & Capital & up & & & & Exchange & Isl.Banks & \\
\hline
September, 1995 & 1000 & 207.6 & - & 347.7 & 144.3 & 648.77 & 81.7 & \\
\hline
\end{tabular}
\end{table}

\begin{table}
\centering
\caption{Continued}
\begin{tabular}{|l|l|l|}
\hline
Employees & Foreign Correspondents & Number of Branches & \\
\hline
462 & 120 & 30 & \\
\hline
\end{tabular}
\end{table}

Source: Al-Arafah Islami Bank Ltd., Dhaka, \textit{Annual Report 2000}.

\textsuperscript{251} Al-Arafah Islami Bank Limited, Dhaka, \textit{Annual Report 2000}. 

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Investment mix of this Bank can be presented through the following pie chart:

- Murabahah
- Bai` Muajjal
- Hire Purchase
- Qard

4. Social Investment Bank Limited

Social Investment Bank Limited (SIBL) is the fourth Islamic bank in Bangladesh. It was incorporated on 5 July 1995 and launched its banking operations on 22 November 1995. It is a joint venture bank of some Islamic organisations such as Islamic Solidarity Fund (of OIC), International Islamic Relief Organisation (IIRO), Saudi Arabia, Islamic Charitable Society, Jeddah, some international Muslim personalities, a group of Bangladeshi entrepreneurs and the Government of Bangladesh. At the operational level, the Bank is committed to provide a linkage among the three sectors of the real economy: the formal, non-formal and Islamic voluntary sectors. At the end of the year 2000 the paid-up capital of the Bank stood at Tk. 120.00 million. The shares in the Bank are held by the following groups of shareholders:
1. Bangladeshi sponsors 43%
2. Foreign sponsors 20%
3. Ministry of religious affairs 05%
4. General public group 32%

Total: 100%

The Bank is managed by a 24-member Board of Directors\textsuperscript{252} including three foreign Directors and its Sub-committee. It has also an 8-member \textit{Shari'ah} Council consisting of Islamic scholars, economists and lawyers. The Council gives opinion on Islamic issues that are generally followed in the Bank. The Bank has opened its principal branch in Dhaka and it has 15 branches all within the country.\textsuperscript{253}

\begin{table}
\centering
\caption{Financial Position of Social Investment Bank Ltd., 2000}
\begin{tabular}{|c|c|c|c|c|c|}
\hline
Established & Authorised Capital & Paid-up Capital & Deposits & Investments & Deposits in other Islamic banks \\
\hline
November 22, 1995 & 1000 & 120 & 226 & 97 & 161 \\
\hline
\end{tabular}
\end{table}

\begin{tabular}{|c|c|c|}
\hline
Employees & Foreign Correspondents & Number of Branches \\
\hline
219 & 5 & 15 \\
\hline
\end{tabular}


\textsuperscript{252} These directors are non-executives.
Investment mix of SIBL can be presented through the following pie chart:

- Murabahah
- Bai` Muajjal
- Hire Purchase
- Musharakah
- Qard and others

5. Faysal Islamic Bank of Bahrain E.C., Dhaka, Bangladesh

Faysal Islamic Bank of Bahrain E.C. (FIBB), opened its branch in Dhaka on 6 March 1997 and began operations in 11 August 1997. The FIBB was set up in 1981, with an authorised capital of one billion US dollars and a paid up capital of 315 million US dollars; and incorporated in Bahrain in 1982.254 The first branch of the Bank in Bangladesh has a management team comprising some 30 local and foreign bankers. The principle activities of Bangladesh branch are to provide all kinds of traditional and specialised banking services to its clients. In order to ensure all functions of the Bank are

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254 Chowdhury, A. Sarwar “Faysal Islamic Banks Opens in Dhaka”, New Horizon, No. 73, March 1998, p.14
performed in strict adherence to the principles of Islamic shari'ah, they are checked and monitored by its Religious Supervisory Board, to whom the management reports periodically. In case of new operations and activities, the Bank management invariably obtains prior approval of the Board.

Table 7.2.5

Financial Position of Faysal Islami Bank of Bahrain E.C., 2000

<table>
<thead>
<tr>
<th>Established</th>
<th>Authorised Capital (US$)</th>
<th>Paid-up Capital (US$)</th>
<th>Deposits (Taka in million)</th>
<th>Investments (Taka in million)</th>
<th>Deposits in other banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 6, 1997</td>
<td>1 billion</td>
<td>315 m</td>
<td>645 m</td>
<td>613 m</td>
<td>-</td>
</tr>
</tbody>
</table>


7.3 Operation of Islamic Banking in Conventional Banks

In Bangladesh, two conventional banks have taken the initiative of providing limited Islamic banking services within their prevailing conventional set-up. These are the Prime Bank Limited and the Dhaka Bank Limited. The Prime Bank had opened two Islamic banking branches, one in Dhaka on 18 December 1995, and the other one in Sylhet on 17 December 1997 respectively. The Dhaka Bank had opened an Islamic banking deposit counter at its principal office in Dhaka since its inception for the depositors of the interest-free accounts. The Bank is considering establishing a separate Islamic branch,

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along with other branches operating in conventional banking. The Prime Bank is the only bank in Bangladesh, which is operating branches on both conventional interest-based banking, and Islamic shari'ah based banking. At the operational side, the operations of Islamic banking of the Prime Bank are maintained separately from the conventional banking. A Shari'ah Board has also been constituted in order to advise and provide guidance on Islamic banking operations.\textsuperscript{256}

Table 7.3

Financial Position of Islamic Branches of The Prime Bank Ltd., 2000

<table>
<thead>
<tr>
<th>Taka in million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
</tr>
<tr>
<td>115</td>
</tr>
</tbody>
</table>

Source: Internal and Islamic Economic Division, Department of Research, Bangladesh Bank.

Investment mix of this Bank can be presented through the following pie chart:

- Murabahah
- Bai` Muajjal
- Hire Purchase

\textsuperscript{256} Ibid., p. 8.
7.4 Performance Evaluation of Islamic Banking in Bangladesh

Performance evaluation is an important pre-requisite for sustained growth and development of any institution in general and in banking sector in particular. Furthermore, the performance evaluation of government business enterprises has taken high profile in the climate of microeconomic reform in the recent past. It is customary in commercial banks to evaluate the pre-determined goals and objectives because in a financial market bank performance gives signal to depositors and investors whether they will deposit/invest or withdraw their funds from the bank. Likewise, it flashes direction to bank managers/financiers whether to improve their services aiming at running the business successfully. With the changes goals and objectives, the criteria for evaluation have undergone changes overtime. To this end, this study approaches an analysis of the productivity measurement of one selective Islamic bank in comparison with its three conventional counterparts of the country. Other analysis although desirable, it could not be made due to resource constrains.

While analysing productivity measurement of Islamic banking in Bangladesh, it would be worthy if all the five Islamic banks operating in Bangladesh can be evaluated. But considering the limit of the scope of this study as well as various constrains, such as resources and availability of data and information, only one Islamic bank of the country, namely Islami Bank Bangladesh Limited (IBBL) has been selected for the purpose of the study in this part. To have a comparison, on the other hand, total three conventional interest-based banks out of which one nationalised commercial bank namely, Agrani Bank (AB), and two private banks namely National Bank Limited (NBL) and Arab Bangladesh Bank Limited (ABBL) have been taken as sample. In order to see how Islamic banking performed over one and half decade of its life, this study with its limited scope, examines
the productivity of IBBL and three other private and nationalised commercial banks of the country. The period covered is between 1986 and 1999. Up to date data in the issue could enrich the study. Unfortunately, more recent data are not available to the researcher. The reason to chose the productivity for measuring banks' performance is that this type of inter-bank analysis is common in bank performance study. This analysis reveals that Islamic banks are doing well in terms of deposit, investment and total employees, and their activities may be extended in the country where people are very much interested with interest-free banking. Because, in Islam, as discussed earlier, practice of trade is an 'ibadah or worship of God, and it is recommended whereas riba is prohibited. In this perspective, Islamic bank is not merely a business firm, but a moral trustee of its depositors where deposits are considered as trust given to the bank. Thus, it is naturally expected that as a custodian of trust for the depositors' deposits, Islamic bank is likely to be more productive and solvent compared to its counterpart conventional bank. Islamic bank management, according to Islamic ethics, is accountable to the depositors in this world and the world hereafter for their failure to keep the trust entrusted upon them. It is, therefore, expected from religious point of view also, i.e., in view of serving religious obligation, that the productivity and solvency ratio of the Islamic banks will be higher than that of conventional banks.

A. Some Highlights of IBBL

Islami Bank Bangladesh Limited started its function in an environment when there was no any Islamic banking tradition in the country. Naturally, in many activities and areas the IBBL learnt by trial and errors. This bitter experience did not happen with other Islamic banks, which started their functions a few years later and had all the advantages of late
starters including having being benefited from the services of some bankers already trained.

The sources of funds of IBBL like other Islamic banks are: (i) Paid-up Capital and Reserves, and (ii) Deposits. Paid-up Capital consists of musharakah principles of Islamic shari‘ah. The highest rate of dividend paid by IBBL on its share money so far is 18% and declared for the year 1995. The principles of deposit collection are known as al-wadi‘ah and al-mudarabah. Like other Islamic banks IBBL cannot invest more than 88% of its deposits as the Bank is under obligation to keep with the Bangladesh Bank 10% of its deposits as Statutory Liquidity Reserve (SLR). In addition, it needs to keep 2% of its deposits at Till Money to meet the day-to-day transactional needs. In practice, IBBL’s investment has never crossed 80% mark and has always suffered from excess liquidity.257

The remaining funds of IBBL are invested through shari‘ah mechanism of investments, namely bai‘ murabahah, bai‘ muajjal, Higher Purchase under shirkatul milk,258 mudarabah, musharakah and bai‘ salam. Moreover, the Bank has taken up various schemes for the well being of the unprivileged and neglected sections of the populace aiming at raising the standard of living of low-income group, developing human resources and creating avenues for self-employment as it claims.

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258 Under this mechanism Bank supplies goods owned by it on rental basis, but the client, after completion of the instalments becomes owner of the goods.
A. A Brief Highlight on the Selected Interest-bearing Banks

1. **Agrani Bank (AB):** All branches of the then Habib Bank Limited operating in Bangladesh was nationalised on 26th March 1972 to form Agrani Bank. Since then, the ownership of Agrani Bank has been retained with the government and the Bank has been playing an important role in the money market as well as in the economy of the country.

2. **National Bank Limited (NBL):** The NBL started its activities in March 1983 with an authorised capital of Tk. 100 million of which Tk. 80 million was paid up. By the end of March 1998, the Bank had authorised capital Tk. 1000 million of which Tk. 391 million was paid up.

3. **Arab Bangladesh Bank Limited (ABBL):** The ABBL incorporated as on 31st December 1981 and started its operation from 12 April 1982. The Bank had Tk. 800 million authorised capital of which Tk. 373 paid up by the end of 1998.

**Analysis of Empirical Results**

Since productivity is chosen for our study to compare between Islamic and conventional banking in Bangladesh, it is necessary to define productivity of a bank at first. Productivity of a bank is defined by Verghege as a measure of an organisation’s effectiveness in using all of its resources, viz. labour, financial resources, fixed assets, premises etc.²⁵⁹ Again, productivity of a commercial bank may be mainly resources productivity, labour productivity and net business productivity.²⁶⁰ Since a bank is not engaged in producing any visible products or goods, naturally it is, to a large extent, difficult to measure its productivity. It is more difficult to measure the productivity of a

non-traditional Islamic bank which has already changed the concept of dealing in money by bank with interest. Because, the objectives and functions of Islamic banking, as stated earlier, although seem to be same as those of conventional banking system, but an Islamic bank is committed with socioeconomic justice and human brotherhood as these are inseparable parts of Islamic ideology. Among the various types of productivity only labour productivity is appropriate for measuring efficiency of a financial institution like commercial bank that usually renders services.

In banking sector, the following indicators may be taken as the basis of productivity measurement.

1. Deposit per employee.
2. Advance/Investment per employee
3. Income per employee
4. Expenses per employee
5. Profit per employee
6. Spread per employee
7. Spread per branch
8. Expenditure per branch
9. Advance per branch
10. Establishment expenses per employee
11. Establishment expenses per branch
12. Deposit per branch
13. Income per branch
14. Ratio of working fund to establishment expenses
Considering various factors, the productivity of the sample banks has been measured by the first five indicators. Table 7.4 presents the summary of financial positions of banks under study. The detailed financial positions are given in Appendix 2.

### Table 7.4

**Summary of the Financial Position of IBBL, AB, NBL & ABBL as Shown in Appendix 2**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Average deposit per employee</th>
<th>Average advances per employee</th>
<th>Average investment per employee</th>
<th>Average expenditure per employee</th>
<th>Average profit per employee</th>
<th>Taka in million</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBBL</td>
<td>6.5038 (2.5)</td>
<td>5.199 (22)</td>
<td>0.0373 (0.0)</td>
<td>0.43425 (1)</td>
<td>0.0994 (1)</td>
<td></td>
</tr>
<tr>
<td>AB</td>
<td>3.7497 (1.6)</td>
<td>2.843 (1.4)</td>
<td>0.8428 (0.4)</td>
<td>0.32111 (1)</td>
<td>0.0342 (0.0)</td>
<td></td>
</tr>
<tr>
<td>NBL</td>
<td>5.4743 (2.5)</td>
<td>3.706 (1.8)</td>
<td>0.6819 (0.3)</td>
<td>0.54803 (.24)</td>
<td>0.1754 (18)</td>
<td></td>
</tr>
<tr>
<td>ABBL</td>
<td>5.5651 (1.58)</td>
<td>4.240 (.25)</td>
<td>0.8235 (32)</td>
<td>0.23021 (.19)</td>
<td>0.1387 (.07)</td>
<td></td>
</tr>
</tbody>
</table>

Source: Annual Reports of the IBBL, AB, NBL and ABBL

Notes:
1. Figures shown in parenthesis indicate standard deviation
2. Abbreviations: IBBL= Islami Bank Bangladesh Ltd.
   AB= Agrani Bank
   NBL= National Bank Ltd.
   ABBL= Arab Bangladesh Bank Ltd.

It is revealed from the Tables shown in Appendix 2 that there has been a continuous increase in both deposit and advances per employee in the case of IBBL as compared to all other selected banks. In this case we may conclude that the productivity of IBBL is relatively good. But investment per employee of IBBL has been found decreasing as compared to all other sample banks, especially during the year 1989 to 1992. It is reported that the recession in investment in those years (1989-1992) was due avoidable circumstances, especially the political instability of the country at that time. Furthermore, IBBL did not accumulate *riba* or interest because of its commitment not to charge any interest. It is also revealed from above mentioned Tables that average per employee advances was the highest in IBBL, which indicates the managerial efficiency

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and commitments of employees of the Bank. As regard to average investment of these sample banks the performance of IBBL is poor as compared to its all other counterparts. The explanation given by the central accounts department of IBBL in this regard is that since the Bank does not involve with investing in interest-based projects its performance in the field of co-sharing investment is relatively small. Besides, the clients, the majority of whom are the businessmen, have not yet come forward to start business with IBBL because of their unfamiliarity of Islamic banking system.

The contradictory point of managerial efficiency of IBBL is that it is in a better position in terms of advances and deposits in the one hand. On the other hand, the expenditure per employee is higher and hence the profit per employee is lower. This indicates that the operation cost of IBBL is higher as compared to all other sample banks. The reason behind these operational expenditures as shown by IBBL itself is that as the Bank gives more emphasis on development of social structure for creating an Islamic environment it has to run some other social development projects with costs such as Islami Bank Hospital, Islami Bank Institute of Technology, Islami Bank Model School and College, Centre for Development Dialogue etc. This should not be the way of banking in the sense of banking concept. However, the outcomes of such projects need to be evaluated in terms of costs and benefits.

In conclusion, the above-mentioned analysis indicates that the progress of IBBL in several cases have been found emerging. It is reported that the Current Assets and Liquidity Management (CALM) has only been achieved by IBBL in Bangladesh. For instance, the total recovery of IBBL in 1995 was 93% in general and 99% in household durable scheme in particular. This is a very good performance of IBBL, which indicates better ‘productivity’ of the same as well. On the contrary, Islamic banks in Bangladesh are
at a considerable disadvantage in facing the competition with conventional banks since they have no access to the money market and are not able to resort to the central bank to solve their liquidity problems.

7.5 Problems of Islamic Banking in Bangladesh

Although the entry of Islamic banking into the field of local financial market of Bangladesh has been well received, it has yet to cross many hurdles before it can claim to be an institution capable of handling the needs of world financial markets. Its initial success may be due partly to the fact that there is a niche market for Islamic funds, and partly to its ethical and intrinsic values. To sustain and develop the system, Islamic banks have to strive to solve the problems, which stand in the way of their growth and survival.

Since Islamic banking is still in the evolutionary stage in Bangladesh, it has been facing a number of problems and challenges, which include:

First, the Islamic banks have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. They face the same problem in financing consumer loans and government deficits.

Second, the risk involved in profit sharing like musharakah and mudarabah modes of investment seems to be so high that almost all of the Islamic banks in Bangladesh have resorted to those techniques of financing which bring them a fixed assured return as murabahah, bai' muajjal, etc. At present, 60%-70% investment of the Islamic banks are on 'mark-up' basis such as murabahah and bai' muajjal, ijarah etc. which represents a change just in name rather than in substance, and would not be of equal significance in achieving the socio-economic objectives of an Islamic economy. As
a result, modes of Profit and Loss Sharing, namely mudarabah and musharakah which is considered to be the real substitute to interest in Islamic banking system, are absent.\footnote{Ahmad, Ziauddin, "The Present State of Islamic Finance Movement", \textit{Journal of Islamic Banking \\& Finance}, No. 4, vol.2, Oct-Dec 1985.}

\textbf{Third}, the Islamic banks do not have the necessary expertise and well-trained manpower to appraise, monitor, evaluate and audit the projects that are required to finance. As a result, they cannot expand despite having huge excess financial liquidity.\footnote{Khan, Muhammad Akram, \textit{An Introduction to Islamic Economics}, Islamabad, 1994, p. 80.}

Despite attracting public attention to its success in terms of mobilisation of deposit and distribution of profit, Islamic banking in Bangladesh yet to achieve the desired level of success due to a number of potential obstacles and problems which can be briefly dealt with here under some major headlines.

\subsection*{1. Absence of Islamic Money Market}

In the absence of Islamic money market in Bangladesh, the Islamic banks cannot invest their surplus fund i.e., temporary excess liquidity to earn any income rather than keeping it in idle. The reason lies behind it is that all the Government Treasury Bills, approved securities and Bangladesh Bank Bills in Bangladesh are interest bearing. Naturally, the Islamic banks cannot invest the permissible part of their Security Liquidity Reserve and liquid surplus in those securities. As a result, they deposit their whole reserve in cash with Bangladesh Bank. Similarly, the liquid surplus also remains uninvested. On the contrary, the conventional banks of the country do not suffer from this sort of limitation. As such, the profitability of the Islamic banks in Bangladesh is adversely affected.\footnote{Bangladesh Bank, Dhaka, \textit{A Brief on the Problems of Islamic Banking in Bangladesh}, undated note, p.4.} The absence of suitable long-term assets available to Islamic banks is mirrored by a lack of short-term tradable financial instruments. Furthermore, it is not clear whether Islamic banks in
Bangladesh can utilise more exotic instruments, such as derivatives, that are becoming increasingly popular with conventional banks. Obviously, these factors place Islamic banking in Bangladesh at a distinct disadvantage relative to its conventional banking counterpart.

2. Lack of Regulatory and Supervisory Framework for Islamic Banking

Another constraining factor for Islamic banking is the lack of a well-defined regulatory and supervisory framework in Bangladesh within which Islamic banks should operate. Regulators have to establish a strong legal system, which may mean a separate law for Islamic banks, appropriate licensing requirements, prudential regulations including minimum capital and liquidity standards, and methods for establishing risk-weighted asset classifications. On the other hand, all the financial and commercial laws of the country are interest oriented. The absence of special legal provisions for Islamic banking in the country has given certain undue advantages to unscrupulous clients. They avail of bank facilities under bai‘ muajjal and bai‘ murabahah mechanism only to default causing income loss to the financier bank. This income loss on overdue investments could have been avoided by suitable legal provisions as have been introduced in Pakistan and Iran.

3. Shortage of Supportive and Link Institutions

Any system, however integrated it may be, cannot thrive exclusively on its built-in elements. It has to depend on a number of link institutions and so is the case with Islamic banking. For identifying suitable projects, Islamic banks can profitably draw the services of economists, lawyers, insurance companies, management consultants, auditors and so

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on. They also need research and training forums in order to prompting entrepreneurship amongst their clients. Such support services properly orientated towards Islamic banking are yet to be developed in Bangladesh.

4. Lack of Suitably Qualified Personnel

Islamic banks lack suitably qualified personnel to conduct their operations. Even though the picture has been improving over the years, further expansion of such banks on the scale observed to date, has come up against this constraint. Thus, not only do Islamic banks in Bangladesh need trained managers, but also they are now in particular need of finance and investment specialists who could create and develop the full range of financial instruments these banks require, to compete with conventional banks. Moreover, for smooth implementation and successful replication of Islamic banking a band of people having dual quality of modern banking knowledge and of shari‘ah methodology is very much needed. The trainers engaged in imparting training to such people at the training academies of the respective banks should therefore, be very clear about the required profile so that they can channel their efforts accordingly.

5. Lack of Organising Relationships with Foreign Banks

Another important issue facing Islamic banks in Bangladesh is how to organise their relationships with foreign banks, and more generally, how to conduct international operations. This is, of course, an issue closely related to the creation of financial instruments, which would be simultaneously consistent with Islamic principles and acceptable to interest-based banks, including foreign banks.
6. Lack of Cooperation among the Shari‘ah Councils

At present, there is no cooperation exists between the Shari‘ah Councils of the Islamic banks in Bangladesh. Individual bank’s Shari‘ah Council takes decisions independently. There is no way developed for mutual discussions nor do they exchange their views on the same issues related to shari‘ah. Rather, they separately provide their opinions which in many cases raises questions about the sanctity of the question, especially in cases where two opposite shari‘ah rulings are found on the same issue to be followed. This individualistic approach of formulation of ruling by the respective Shari‘ah Councils may create confusion among the general people to bank with them.

7. Non-existence of a Central Shari‘ah Supervisory Board

In some countries, especially in Pakistan, Iran and Malaysia have their central supervisory boards/councils working under the central banks in order to investigate and supervise the operations of Islamic banks whether they are operating in line with the shari‘ah principles. Although all Islamic banks in Bangladesh have their own Shari‘ah Councils/Boards, at present, there is no such central shari‘ah supervisory board or council in Bangladesh under Bangladesh Bank to guide, supervise and monitor activities of the Islamic banks more closely and accurately as well as to foster coordination among the Shari‘ah Councils of Islamic banks.

8. Absence of Institutional Mechanism

To ensure the compatibility of all operations of Islamic banks with the requirement of shari‘ah is to have an institutional mechanism whereby management of banks have an easy and continuing access to Islamic scholars and jurists reputed for their piety and
authoritative knowledge of Islam for consultations in evolving the operating procedures, and where in turn these scholars have full opportunity of scrutinising the actual operating procedures of the banks. In the absence of any institutionalised arrangements of such a nature, there is a risk that some of the practices adopted by the banks may not be in harmony with the requirements of *shari‘ah*.

9. **Lack of Co-ordination among the Islamic Banks**

Although a forum named ‘Islamic Banks Consultative Forum’ was constituted by the all Islamic banks in March 1997 with the cooperation from Bangladesh Bank to provide suggestions on six major areas related to them, namely a) formation of Islamic money market, b) central *Shari‘ah* board, c) Islamic banking act, d) Islamic insurance company, e) new financial products in line with the *shari‘ah* and f) constitution of consortium/syndication by the Islamic banks for large financing, presently it is not fully active. The inactivity of such a central forum of Islamic banks in Bangladesh has created significant problems that need to be overcome if there is to be further progress, and especially if Islamic banks are going to be credible competitors to conventional banks.

Beside the problems, obstacles and challenges listed above, there are some particular set of issues confronting Islamic banks in Bangladesh which need to be addressed, if Islamic banking is to reach a level that would place it at par with conventional interest-based banking. A partial list of these issues include:

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265 *Bangladesh Bank, Dhaka, On the Dynamism of Islamic Banking in Bangladesh* a letter issued to all the Islamic banks and banks having Islamic banking branches and counters on March 15, 1997 (letter No. DR/PIED (IEC) 1/97)
1) Lack of accounting principles and procedures
2) Hard competition in the financial sector
3) Economic slowdown and political instability of the country
4) Inadequate track record of Islamic banking
5) Defaulting culture of the borrowers
6) Lack of course or research on Islamic banking at the educational institutions
7) Lack of uniform operational procedure of Islamic banking
8) Lack of inter-country study on the practical operations of Islamic banking
9) Lack of apex training institute for the Islamic banks
10) Reluctance of the management to be strict with shari'ah guidelines
11) Lack of co-operation between Islamic banks and Islamic NGOs for extending micro-credit
20) Using a combination of the different financing techniques permissible in shari'ah
21) Orientation of Islamic banks mainly towards short term financing of trade transaction
22) Lack of intention of a number of pious Muslims to deposit their savings in Islamic banks for not maintaining strictly by them the Islamic prohibition of interest
23) Lack of full-fledged shari'ah audit
24) Lack of shari'ah manual or guidelines
25) Utilisation of interest rate for fixing the profit margin in bai' modes.
7.6 The Future of Islamic Banking in Bangladesh

The Islamic banking in Bangladesh would be regarded as Islamically successful in future if it succeeds both in eradicating interest from its transactions and promoting commerce and trade. Islamic banks may and should concentrate exclusively on acceptable and profitable economic activity, such as trading, for instance, in commodities, property investment, property development and asset leasing. They should solicit deposits for direct investment in those activities, and trade, therefore, as quasi-investment banks. At the same time they cannot, any more than can any other financial institution, ignore the realities and costs of inflation, which permeate the international economy. They can only solve this problem by being profitable enough to meet the need to maintain the value of their depositors' funds.

It might be 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 shari'ah rules. It is also suggested that some specialised Islamic financial institutions such as mudarabah banks, murabahah banks and musharakah banks to establish in the country that would compete with one another to provide the best possible services for the clients.
The survival and vitality of Islamic banks depend ultimately on the quality of the services offered to clients. Failure to provide the full range and high quality services will inevitably mean that clients will switch from the Islamic counters to conventional banks. The Islamic banks should therefore learn from the techniques and experience of conventional banking whatever will assist them to improve their marketing techniques and define and deliver services to clients. Second, the Islamic banks must institute a formal, structured staff-training programme. In addition, Islamic banks' staffs would need training in the relevant areas of Islamic law, as well as in conventional financial techniques.

The future of Islamic banking in Bangladesh depends upon it proving its usefulness to the nation from the point of view of socially responsible investments. There will always be a question mark over the real difference between it and conventional banking. It is important for people to see that Islamic banking gives a tangible form to its religious ideology. The problems and challenges it faces is to prove that it is possible to be both economically productive and compassionate, to seek both economic self-interest and the interest of others, and that there is no contradiction between ethics and professionalism, competence in one's field and a permanent commitment to good work in that field.

Review of the problems of Islamic banking in general and of Islamic banking in Bangladesh in particular poses a challenging feature for the promotion and survival of Islamic banks in Bangladesh. The policy implication is not that Islamic banks should never be floated within the conventional banking framework. Rather it is the conventional banking system whose operational mechanism needs to be examined and converted into PLS system considering beneficial impact of the latter on the economy. However, as long
as Islamic banks are to operate within the conventional banking framework, the recommendations under the following heads may be taken note of.

1. Future Policy and Strategy

The action that deserves immediate action by Islamic banks is the simultaneous promotion of the image of Islamic character and solvency as banks. Strategies have to be carefully devised in this regard. To this end, pilot schemes in some very selected areas should be started to test innovative ideas with PLS modes of financing as major component. Islamic banks should clearly demonstrate by their actions that their banking practices are guided by profitability criterion thereby they have to ensure efficient allocation of resources and provide true market signals through PLS modes. Besides, they should continuously monitor and disseminate through various means the impact of their operations on the distribution of income primarily between the bank and the depositors and entrepreneurs, and then on different income groups of the country. These presuppose establishment of fully equipped research academy in each Islamic bank.

2. Balance Between the Ideals and Practice

There seems to be a gap between the ideals and actual practice of Islamic banks in Bangladesh. In their reports, booklets, bulletins and posters these banks express their commitments to striving for establishing a just society free from exploitation. Though this failure is attributed mainly to the pervasive influence of conventional banking system itself, lack of vigilance of the promoters of Islamic banking in realising the objective is no less to blame. There should be thorough review of policies that have been pursued by these
banks for about two decades and points of departure have to be identified to redesign their
course of action.

3. Promotion of Distributional Efficiency

The task is more challenging for Islamic banks, as they have to promote their
distributional efficiency from all dimensions together with profitability. Islamic banks,
step by step, have to be converted into profit-loss-sharing banks by increasing their
percentage share of investment financing. The Islamic banks, to do that, can be selective in
choosing clients for financing under PLS modes. They should establish a direct functional
relationship between the income of the depositors and between the income of the bank and
that of the entrepreneurs.

4. Promotion of Allocative Efficiency

Islamic banks can improve their allocative efficiency by satisfying social welfare
conditions in the following manner:

a) They should allocate a reasonable portion of their investible funds to social
priority sectors such as agriculture (including poultry, fishery etc.), small and
cottage industries and export oriented industries.

b) When the percentage shares of allocation of investible funds are determined
among the sectors of investment financing, profitability of projects should be
the criterion for allocating investment funds. The criterion would be satisfied if
more and more projects were financed under PLS modes.
5. Modern Banking Practices

Islamic banks, with a view to facing the growing competition either from fellow-Islamic banks or the conventional banks which have lunched Islamic banking practices, will have to adapt their functioning in line with modern business practices through improvement of the range of dealings in the banking sector. Thus, it is necessary for them to provide comprehensive banking and investment services to clients and simultaneously to take advantage of modern communication technology.

6. Responsibility of Central Bank

Bangladesh Bank – the central bank of the country should have some responsibilities for the promotion of Islamic banking considering its central regulations. It can develop some Islamic Monetary and saving instruments and create separate window for transactions with the Islamic banks. It can develop a full-fledged Islamic Banking Department for analysing, supervising, monitoring and guiding purpose, thereby facilitating Islamic banks for their smooth development in Bangladesh. Government may play an active role to create favourable environment conducive to smooth operation of Islamic banks. The Bank Reforms Committee may be entrusted to draft an Islamic Banking Act.

Last, but not least, the success of Islamic banking depends heavily on its ability to find a viable alternative to interest for financing all types of loans. It should acknowledge that its success in abolishing interest has been, at the least, partial, and that it still has a long way to go in its search for a satisfactory alternative. Training its personnel in project-appraisal, monitoring, evaluation and performance auditing will surely more quickly travel part of that way if it improves its managerial capabilities. Its future depends also on its ability to develop, and put into practice, accounting standards that provide timely and
reliable information for profit sharing, and rent sharing or for cost-plus financing transactions. Until they are, it is an uphill task for Islamic banks to persuade clients not already persuaded to believe that they, the banks have a sufficient and reliable information base from which to conduct and expand their business.

It is important to remember that the Islamic banking movement has been around for only 30 years, so it is unfair to compare its results with those of the conventional banks, which have been established for more than 300 years. Islamic banking is still an on-going phenomenon, still in the making. The challenge for Islamic banking is whether and how to go on surviving, then to succeed and so become an established, permanent phenomenon.

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Chapter VIII

CONCLUSIONS AND RECOMMENDATIONS
CONCLUSIONS AND RECOMMENDATIONS

8.1 Summary Conclusion

As stated in the introductory chapter, the primary objective of the present study was to analyse the issues concerning the Islamic banking in Bangladesh. To achieve this objective, first, a methodological approach to understanding Islam was developed. Second, the study critically examined how the structure and practices of Islamic banking differ from those of conventional banking. Following that, it investigated the problems and challenges facing by the Islamic banks in the Muslim and non-Muslim world in general, and those faced in Bangladesh in particular. The second objective was to evaluate the performance of Islamic banks in Bangladesh. To achieve this objective, the study conducted a comparative analysis of the areas of similarity and differences between Islamic and conventional banking system. To this end, an empirical analysis is also made on the performance of Islamic and conventional banks in Bangladesh during the period 1986-1999. The rest of the study presented a comprehensive review on different issues related to the subject, which can be summed up as follows:

(1) Shari'ah that derived from the two primary sources namely al-Qur'an and the sunnah, which are supplemented by the two ‘dependent’ sources of fiqh, namely ijma’ and qiyas, is the foundation for all Islamic laws and regulations. The Islamic principles that have shaped the evolution of modern Islamic banking and finance are found in shari’ah, within which the most fundamental limiting principle on banking activity is the avoiding of riba.
(2) The economic aspect, being an integral part of human life, forms the basis of economic system in Islam and for humanity in general. It has given equal importance to the material life and moral principles and has struck a balance between individual rights and social welfare and obligations. From this perspective, the fundamental Islamic objective of distributive justice is described as the guarantee of fulfillment of basic needs of people in society. The avoiding of riba, obligation of the payment of zakah, freedom of trade and profession, prohibition of socially harmful economic activities, absolute ownership of God and trust ownership of mankind are adequate elements for such a moral economic system.

(3) The banking system, when first introduced into Islamic societies, did not flourish as it was not consistent with the fundamentals of the shari‘ah. Islamic banking as now practiced is based on Islamic rules and norms and has accordingly to promote the Islamic concept of socio-economic development.

4) Islamic banks, though controlled by the rules of shari‘ah, essentially perform the same functions as those under other systems, but differ from banks under other systems due to the different nature of their operation. For example, a) contrary to an Islamic bank, the bank-customer relationship in a conventional bank is creditor-debtor or lender-borrower; b) an Islamic bank makes a legitimate profit or variable return from its trading activity while a conventional bank merely finances the customer at a fixed interest rate; c) although both have to take similar risks in credit, capital adequacy, liabilities, currency fluctuation, liquidity etc. the risks under Islamic banking system are relatively higher due to its extensive trade and investment activities.
(5) The outright opposition to *riba* came from the philosophers and moralists in classical times as it involved paying for time, which they considered to be morally wrong. The Islamic standing on usury or interest is that it prohibits it outright and what is clearly permissible is a return from a partnership. Islam calls for a share of risk between the lender and borrower. It rejects time as a justification for the payment of interest and says that when gain is sought from an activity not in itself productive without labour, expense or risk on the part of lender, it is illegitimate and reprehensive.

(6) Addressing *riba*, being one of the most important Islamic prohibitions from a historical as well as an Islamic financial perspective, the study pointed out the approach of the *Qur'an* in attacking the root of an economic problem. Then the interpretation of *sunnah* on the issue was discussed. Following this the modernists and conservatives’ views on the doctrine of *riba*, the avoidance of which establishes the religious identity of an Islamic bank, were critically reviewed.

(7) The existence of Islamic banking products can be traced back to the early days of Islam while conventional banking products started to emerge with the revival of commercial activities during the 13th century. As a result of colonisation the banking system in Muslim countries including Bangladesh followed conventional banking rules. Although the first attempt to establish an Islamic bank was made in Malaysia in the mid 1940’s, the establishment of the Myt Ghamr Savings Bank in Egypt in the Sixties marked a new milestone in the modern world of banking.

(8) As the case with conventional banks, profitability is considered as one of the important objectives of Islamic banks. On the contrary, in line with the main purpose of the existence of Islamic banks they are expected to include social and moral aims as well as profit in their objectives, that is to promote, foster and develop banking services and
products based on Islamic principles. They are also expected to conform to Islamic business principles not only through eliminating the element of *riba* in their operations, but also engaging themselves in lawful businesses, fulfilling all obligations and responsibilities, conducting business with honesty and distributive justice, and executing transactions in a proper manner.

(9) The main source of funds for Islamic banks is from deposits made by customers, which basically include three types of accounts – current, savings and investment accounts. In the case of current accounts that are designed for depositors’ convenience, no returns are given to them and they can withdraw their funds at any time without notice. Returns on savings accounts (which are for customers wishing to save and earn income) and on investment accounts (for depositors having investments motives), are not pre-determined as they are based on the profit-sharing concepts of *mudarabah*.

(10) Since Islam ordains to avoid *riba* in all its forms and for any purpose as majority of Muslim scholars opine, they have identified some *shari‘ah* principles which are suitable for usage by Islamic banks. These principles can be broadly classified into four categories, namely (a) principles that are based on profit and loss sharing concepts (such as *mudarabah* and *musharakah*); (b) principles that are based on fees or charges based principles (such as *murabahah*, *bai‘ muajjal*, *ijarah*, *ijarah wa iqtina*); (c) principles that are based on free of charge transactions (such as *qard hasan*); and (d) principles that are directly applicable to the operations of Islamic bank (such as *wadi‘ah* and *rahn*). Other normal banking services are also available at Islamic banks, which are considered fee-based activities. Muslim scholars consider both *mudarabah* and *musharakah* as

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267 In *shari‘ah*, the word *rahn* stands for pledge or security for the satisfaction of debt if the debtor failed to repay it and whatever validly forms the subject of sale may be given as security.
strongly Islamic, and the remaining principles as weak as they are to be used only in cases where profit and loss sharing concepts cannot be implemented.

(11) Although Islamic banks have come to existence recently, they have expanded rapidly and at the present time they are actively participating in the international financing. There are, however, some factors that act to the detriment of Islamic banks. These includes *inter alia* their difficult relationship with the monetary authorities, the lack of adequately skilled staff and the absence of Islamic financial instruments which could help to widen their dealings with the international financial markets. None of these issues has been solved and this will continue to affect the growth of Islamic banks.

(12) At present the banking system of Bangladesh (where almost 88% of its people are Muslims), consists of 39 banks in the private and public sector. Of these 4 local and 1 foreign bank operate as full fledged Islamic banks in the private sector. In additions, two conventional banks in the private sector have also been partially dealing with the Islamic banking business since their inception. Although the Islamic banking system appeared on the financial horizon of this country only in 1983, its growth trends and potentiality indicate that this interest-free welfare banking system is well accepted in the society where interest-based conventional banking system is also working side by side. Knowledge of Islamic economic and banking terms has created a strong awareness and consciousness of the system.

(13) Islamic banking is especially important in the economy of third world countries like Bangladesh which are characterised by unemployment, poverty, inequitable distribution of income and wealth etc. Although the emergence of Islamic banking in the field of local financial market of Bangladesh has been well received, and its success in terms of mobilisation of deposit and distribution of profit attracted the attention of people,
there are many hurdles it has yet to cross before it can claim to be a successful institution to handle the world financial markets. To uphold and augment the system, it has to make every effort to solve the issues and problems that obstruct its growth and survival.

(14) It must be admitted that Islamic banking is still passing its nascent stage in Bangladesh and its impact on the underdeveloped economy of the country cannot be said to be at the highest level. It is not simply possible for a few Islamic banks to change the direction of an economy and improve the socio-economic conditions till the government of the country amends existing banking laws, acts and regulations for smooth functioning of Islamic banks.

(15) The success of Islamic banking in future in Bangladesh though Islamically depends heavily on its ability to find a viable alternative to interest for financing all types of loans through promoting commerce and trade. It still has a long way to go in its search for a satisfactory alternative. Furthermore, it should concentrate exclusively on profitable economic activities and solicit deposits for direct investment in those. On the other hand, the vitality and survival of Islamic banks depend eventually on the quality of their services offered to clients, failure of which will make them switch to their conventional counterparts.

Given the above summary of the study, it is concluded that although profit and loss sharing framework is central to the theory of Islamic banking, the unavoidable implication is that this is not practiced within the current environment prevailing in Bangladesh. Islamic banks can be regarded as successful if they strictly follow Islamic principles of banking and finance, and at the same time concentrate exclusively on acceptable and profitable economic activities of the country as well as ask deposits from the clients for
direct investment in those activities as quasi-investment banks in order to achieve their ethical-social objectives.

Islamic banking institutions in Bangladesh have been able in most cases to successfully perform usual functions of the conventional banks strictly on interest-free basis and the progress made by them is encouraging at least in achieving the conventional banking objective of profitability and safety. This study shows that Islamic banks are financing mostly on the basis of risk free techniques so as to maintain its viability and growth in the capitalistic financial environment in Bangladesh.

8.2 Some Recommendations

In order to be more efficient, effective and successful to achieve Islamic banks’ underlying goals and objectives the following suggestions and recommendations may be taken into consideration for Islamic banking institutions.

(1) Since one of the main features that characterise the institutions of Islamic banking is to contribute to the Islamic concept of socio-economic development, they are expected to fulfill their role in Islamic society by applying a socio-economic oriented business policy. They are also expected to favour projects that reflect the needs of the majority of the population and also select projects, which generate a high rate of socio-economic benefits. In addition, they should develop a credit policy that is specific to each firm’s economic and financial conditions.

(2) The objective of Islamic banks is a combination of profit and socio-economic benefit maximisation. They will not act as welfare institutions only but they should maximise the return on share capital and distribute a competitive return to the depositors.
(3) In line with the philosophy of Islamic banking, Islamic banks in Bangladesh came into existence with some objectives, which imply a direct and specific responsibility on their parts to play an effective role in socio-economic development of the country. It is apparent that Islamic banks have concentrated on short-term commercial activities to maintain their existence in the market. However, the policy of achieving and maintaining high profit is essential for the success of Islamic banks.

(4) In order to achieve their goals, Islamic banks are expected to increase the rate of savings by attracting into the banking system new savers who refuse to deposit their funds at interest-based conventional banks. They are also expected to pay particular attention to the fundamental attitudes of small savers who have been neglected by their conventional counterparts. Furthermore, it is intended that Islamic banks design an informative programmes on savings, which stresses the development of financial habits and understanding the benefits that occurs from savings.

(5) Although the existing shari‘ah principles of banking and finance are considered sufficient to facilitate all modern banking products and services, they should also include laws, practices, procedures and instruments which help in the maintenance and special consideration of distributive justice and equity. So, areas like banker-customer relationship, legal considerations underlying the bank’s products and services, legal considerations varying the types of customers, duties and responsibilities as a paying and collecting banker, legal actions against the customer, aspects of financing etc. should be reviewed and tailored under Islamic shari‘ah.

(6) As the two monetary policy instruments used by the central bank, namely open market operations and discount rates to control money supply in the country, are not applicable to the Islamic banking system unlike to its conventional counterpart, alternative
financial instruments permissible in shari'ah are recommended to be used by the Islamic banks. It is suggested by some Muslim scholars that the central bank of the respective country should participate directly as a co-financier on a profit-sharing basis on projects financed by an Islamic bank.

(7) The spread of Islamic banks not only would improve the interregional flows of funds, it would also reduce the disparities in the cost of borrowing, and invest the mobilised resources in the rural areas. In order to achieve their socio-economic objectives they should also to improve the living standards of the small and marginal farmers in generating increased demand for the agricultural products.

(8) Islamic banks usually use deposit of branches in rural areas in one way or another to fund investment in urban areas. This transfer of rural area savings will have an adverse effect on the growth rate of these backward areas. In this respect one might recommend that Islamic banks should adopt a “growth from below” policy with more emphasis on the financing of small-scale economic activity in industry and agriculture.

(9) The issue of poverty and unemployment are considered the major issues of the third world countries. Being one of the poorest country in the world and having limited job opportunities in the country a large number of university graduates in Bangladesh are unemployed. Islamic banks may play an active role through their welfare-oriented activities to create job opportunities for those unemployed graduates.

(10) Despite the fact that for some reasons the murabahah or mark-up based financing has gained a singular momentum in modern Islamic banking operations rather it should concentrate on trade-related modes of financing over production related activities. But in a bid to abolish the evils of modern banking it is proposed that Islamic banks will try to incorporate the principles of PLS mechanism in their current investment decision
and increase the PLS ratio in total investment through implementing special clientele and project development programmes on urgent basis.

(11) Islamic banks are expected to utilise their idle funds in the proper Islamic way. In order to contribute more for the economic development of the country and encourage their customers to have investment accounts in the banks as well, they should emphasise more on the long term financing based on mudarabah and musharakah, which are considered as the chief alternative to riba.

(12) Islamic banks are required to participate more in improving the productivity of the existing capital by extending their services. Since Bangladesh is a poor country, there is a great need for financial institutions including Islamic banks to collect and invest the savings of the people and institutions within its borders.

(13) Islamic banks are found depending to a great extent on religious commitments of depositors to maintain their market share rather than in the offering of competitive and widespread services. Since the majority of depositors in Bangladesh are from low-income groups, Islamic banks should attract more customers through extending a wide range of credit facilities and realising high returns on investment deposit so as to avoid endangering their market share. In other words, Islamic banks should build their bank-customer relationship on economic rather than religious considerations.

(14) The monetary and credit policies followed by Bangladesh Bank have become stringent. The size, form and utilisation of deposit with conventional banks in general and Islamic banks in particular have been crippled by Bangladesh Bank. In this regard, the recommendation is that the credit policy should be flexible with banks so long as they direct more finance to certain economic sectors or activities in line with the objectives of the development plan of the country.
(15) There can be no doubt that the development goals adopted by Islamic banks coincide with the needs of the national economy and help accelerate its growth. Islamic banks are earnestly hoped to extend finance to small investors, producers, craftsmen, fishermen and small industrialists, particularly those in rural areas. However, as mentioned earlier, regarding the liability side of Islamic banks, they are capable of financing investment projects of a long-term nature.

(16) To become efficient, Islamic banks should find more standardised financial instruments and innovations in accordance with the shari‘ah principles, which will enable them to deal with other interest-based conventional banks. Likewise, Islamic banks should develop a secondary financial market for Islamic financial products if they wish to achieve a true comparison with their conventional counterparts. They must also work hard to develop more transparency in financial reporting, auditing and accounting. In addition, they should have their own inter-bank money markets to become a strong national invigorating force in real sense.268

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APPENDICES

APPENDIX 1

Islamic Banks and Financial Institutions around the World

AFGHANISTAN
1. Islamic Bank Afghanistan

ALBANIA
2. Arab Albanian Bank

ALGERIA
3. Banque Albaraka D’ Algeria

ARGENTINA
4. Islamic Pan-American Bank

AUSTRALIA
5. Iskan Finance Pty Limited
6. Islamic Co-operative Finance Australia Limited (ICFAL)
7. Muslim Community Co-operative Australia (MCCA)

BAHAMAS
8. African-American Islamic Bank
9. Dar Al-Maal Al-Islami Trust
10. Faysal Islamic Bank of Bahamas Limited
11. International Islamic Trading Limited
12. Islamic Investment Company of Gulf-Bahrain
13. Islamic Takaful and Retakaful Company Limited
14. Masraf Faysal Al-Islami (Bank and Trust) Bahamas Limited

BAHRAIN
15. ABC Islamic Bank
16. Al-Ameen for Security and Investment Funds
17. Al-Baraka Islamic Investment Bank
18. Al-Tawfeek Company for Investment Funds
19. Arab Banking Corporation
20. Arab Islamic Bank E.C.
21. Bahrain Islamic Bank
22. Bahrain Islamic Investment Company
23. City Islamic Investment Bank E.C.
24. Faysal Islamic Bank of Bahrain E.C.
25. Faysal Investment Bank of Bahrain
26. First Islamic Investment Bank E.C.
27. Gulf International Bank
28. Islamic Insurance and Re-Insurance Company
29. Islamic Investment Company of the Gulf
30. Mashareq Faysal Al-Islamic
31. Takaful Islamic Insurance Company

BANGLADESH
32. Al-Arafah Islami Bank Limited
33. Al-Baraka Bank Bangladesh Limited
34. Far East Islamic Life Insurance Company Limited
35. Faysal Islamic Bank of Bahrain E.C.
36. Islami Bank Bangladesh Limited
37. Islamic Commercial Insurance Limited
38. Islamic Insurance Bangladesh Limited
39. Social Investment Bank Limited

BRUNEI
40. Insurans Islam TAIB Sdn Berhad
41. Perbadanan Tabung Amana Islam

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42. Takaful IBB Berhad
43. The Islamic Bank of Brunei Berhad

**CAYAMAN ISLANDS**
44. Al-Tawfeek Company for Investment Funds

**CYPRUS**
45. Faisal Islamic Bank of Cyprus
46. Faysal Islamic Bank of Kibriz Limited, Turkey, Cyprus
47. Kibriz Islamic Bank, Kifcosa, Nicosia, Turkey, Cyprus

**DENMARK**
48. Faisal International Bank A.S.
49. Islamic Bank International

**DJIBOUTI**
50. Banque Albaraka Djibouti

**EGYPT**
51. Arab Investment Bank, Cairo
52. Bank Misr - Islamic Branches
53. Egyptian Saudi Finance Bank
54. Faysal Islamic Bank of Egypt
55. General Investment Company, Cairo
56. Islamic International Bank for Investment and Development
57. Islamic Investment and Development Company, Cairo
58. Nasser Social Bank

**GAMBIA**
59. Arab-Gambian Islamic Bank Limited

**GERMANY**
60. Al-Baraka Investment Company, Frankfurt

**GUINEA**
61. Banque Islamique de-Guinec
62. Faysal Islamic Bank of Guinea
63. Islamic Investment Company
64. Masraf Faysal Al-Islami

INDIA
65. Al-Ameen Finance and Investment Company
66. Al-Baraka Finance House
67. Amanah Bank, Bangalore
68. Falah Investment Limited, Bombay
69. Ittefaq Investment Limited, Bombay

INDONESIA
70. Al Barakah Jakarta Representative Office
71. Bank Muamalat
72. PT BPR Aitur Berkah Gemedana
73. PT BPR Amanah Rabbaniyah
74. PT BPR Amanah Ummah
75. PT BPR Artha Karimah Insyadi
76. PT BPR Babussalam
77. PT BPR Baituniage Insani
78. PT BPR Baituridha PT BPR
79. PT BPR Bangundrajad Warga
80. PT BPR Barkah Gemadana
81. Berkah Amal Sejahtera
82. PT BPR Bina Amwanul Hasanah
83. PT BPR Dana Mardatillah
84. PT BPR Dana Tijarah
85. PT BPR Hareukat
86. PT BPR Harta Insan Karimah
87. PT BPR Ikhwatul Ummah

225
88. PT BPR Inti Raqaat
89. PT BPR Margrizki Bahagia
90. PT BPR Mentari
91. PT BPR Qiradh
92. PT BPR Saleh Artha
93. PT BPR Uswatun Hasanah

IRAN
94. Agricultural Bank of Iran
95. Bank Maskan
96. Bank Mellat Iran
97. Bank Milli Iran
98. Bank of Industry and Mine
99. Bank Refahe Karedgan
100. Bank Sadarat Iran
101. Bank Sepah
102. Bank Tejarat
103. Export Development Bank of Iran
104. Islamic Banking System
105. Islamic Bank, Tehran

IRAQ
106. Biet El-Mal Savings and Investment Company
107. Iraqi Islami Bank for Development and Investment

JORDAN
108. Beit El-Mal Savings and Investment Company
109. Islamic International Arab Bank
110. Islamic Investment House
111. Jordan Finance House, Amman
112. Jordan Islami Bank for Finance and Investment

226
113. National Islamic Bank

**KAZAKHSTAN**

114. Al-Baraka Kazakhstan International Commercial Bank
115. Lariba Bank
116. National Islamic Bank

**KIBRIS TURKISH REPUBLIC**

117. Faisal Islamic Bank of Kibris Limited K.T.R.

**KUWAIT**

118. International Investment Group
119. Kuwait Finance House
120. The International Investor
121. The Security Home Company (Arzaaq Fund)

**LEBANON**

122. Al-Baraka Bank Lebanon

**LIECHTENSTEIN**

123. Arinco Arab Investment Company
124. IBS Finance S.A.

**LUXEMBOURG**

125. Faysal Holding S.A.
126. Islamic Banking System International Holding S.A.
127. Islamic Finance House Universal Holding
128. Islamic Takaful Company

**MALAYSIA**

129. Al-Baraka Bank Malaysia
130. Bank Islam Malaysia Berhad
131. Dallah Al-Baraka Malaysia Holding
132. Islamic Economic Development Foundation
133. Lembaga Tabung Haji
134. Pilgrims Management and Fund Board
135. Senderian Berhad
136. Syarikat Takaful Malaysia
137. Zakat Collection Centre

MAURITANIA
138. Banque Al-Baraka Mauritanienne Islamique

MOROCCO
139. Bank Al-Aqeedah, Morocco

NIGER
140. Banque Islamic du Niger Pour le Com. Et l'Inv.
141. Faisal Islamic Bank of Niger
142. Islamic Investment Company
143. Mashreq Faisal Islamic

PAKISTAN
144. ABN Amro Bank N.V.
145. Agricultural Development Bank of Pakistan
146. Al Faysal Investment Investment Bank Limited
147. Al Towfeek Investment Bank Limited
148. American Express Bank Limited
149. ANZ Grindlays Bank PLC
150. Askari Commercial bank Limited
151. Bank Al-Falah Limited
152. Bank Al-Habib Limited
153. Bankers Equity Limited
154. Bank of America NT & SA
155. Bank of Khyber
156. Bank of Punjab
157. Bank of Tokyo Limited
158. Bolan Bank Limited
159. Chase Manhattan Bank N.A.
160. Citibank N.A. Pakistan
161. Credit Agricole Indosuez
162. Deutsche Bank (AG)
163. Dhoha Bank Limited
164. Emirates Bank International Limited
165. Faysal Bank Limited
166. Federal Bank for Co-operatives
167. First Allied Bank Modaraba
168. First Habib Modaraba
169. First Women Bank Limited
170. Habib Bank Limited
171. Habib Credit and Exchange Bank Limited
172. Hong Kong and Shanghai Banking Corporation
173. House Building Finance Corporation
174. Indus Bank Limited
175. Industrial Development Bank of Pakistan
176. International Finance Investment and Commercial Bank Limited
177. Investment Corporation of Pakistan
178. Mashreq Bank P.S.C.
179. Mehran Bank Limited
180. Metropolitan Bank Limited
181. Muslim Commercial Bank
182. National Bank of Pakistan
183. National Development Finance Corporation
184. National Development Leasing Corporation
185. National Investment Trust Limited
186. Pakistan Industrial Development Corporation
187. Pak-Kuwait Investment Company Limited
188. Pak-Libya Holding Company (Pvt.) Limited
189. Pan African Bank Limited
190. Prime Commercial Bank Limited
191. Prudential Investment Bank Limited
192. Punjab Provincial Co-operative Bank
193. Regional Development Finance Corporation
194. Rupali Bank
195. Saudi-Pak Industrial and Agricultural Investment Company Limited
196. Small Business Finance Corporation
197. Societe Generale Investment
198. Soneri Bank Limited
199. Standard Chartered Bank
200. Union Bank Limited
201. United Bank Limited
202. Youth Investment and Promotion Society

**PALESTINE**

203. Al-Aqsa Islamic Bank
204. Palestinian Islamic Bank

**PHILIPPINES**

205. Al-Amanah Islamic Investment Bank of Philippines
206. Amanah Bank, Lamboangah
207. Philippines Amanah Bank

**QATAR**

208. Al-Jazeera Investment Company
209. Islamic Exchange and Investment Company
210. Islamic Investment Company of the Gulf (Qatar)
211. Qatar International Islamic Bank
212. Qatar Islamic Bank

RUSSIA
213. Badr Bank

SAUDI ARABIA
214. Al-Baraka Investment and Development Company
215. Al-Rajhi Banking and Investment Corporation
216. Islamic Development Bank
217. Islamic Investment Company of Gulf Bahamas
218. National Commercial Bank

SENEGAL
219. Banque Islamic du Senegal
220. Faysal Islamic Bank
221. Islamic Investment Company
222. Mashareq Faysal Al-Islami

SOUTH AFRICA
223. Al-Baraka Bank Limited
224. First Muslim Interest-Free Business Institution
225. Islamic Bank, Durban

SUDAN
226. Agricultural Bank of Sudan
227. Al-Baraka Bank Sudan
228. Al-Safa Investment and Credit Bank
229. Animal Resources bank
230. As-Shamal Islamic Bank
231. Bank of Khartoum
232. Blue Nile Bank Limited
233. Citibank N.A.
234. Co-operative Islamic Bank Development
235. Elgharb Islamic Bank
236. El-Neilin Industrial Development Bank
237. Farmers' Bank for Investment and Rural Development
238. Faysal Islamic Bank Sudan
239. Habib Bank Limited
240. Islamic Co-operative Development Bank
241. Islamic Investment Company
242. Mashreq Bank
243. National Bank of Abu Dhabi
244. National Bank of Sudan
245. National Development Bank
246. Nima Development and Investment Bank
247. Ombudsman National Bank
248. Saudi-Sudanese Bank
249. Savings and Social Development Bank
250. Sudan Commercial Bank
251. Sudanese Estate Bank
252. Sudanese French Bank
253. Sudanese Islamic Bank
254. Sudanese Savings Bank
255. Tadamun Islamic Bank
256. Workers' National Bank

SWITZERLAND

257. Dar Al-Maal Al-Islami (DMI)
258. Faisal Finance (Switzerland) S.A.
259. Islamic Investment Company Limited
260. Islamic investment pool (Union Bank of Switzerland)
261. Khiro Credit Bank Switzerland limited
262. Shariah Investment Services S.A.
263. Takwa Bank

THAILAND
264. Arabian-Thai International Company
265. Arabian-Thai Investment Company, Bangkok

TUNISIA
266. Al-Saudi-Al-Tunisi Financing House
267. Beit Ettamwil Tunisi-Saudi

TURKEY
268. Al-Baraka Turkish Finance House
269. Andalu Finance Kurumu A.S.
270. Faysal Finance Institution incorporated
271. Faysal Foreign Trade & Market Company
272. Faysal Islamic Bank of Kibris
273. Faysal Real Estate Construction & Trading Company
274. Kuwait-Turkish Awkaf Finance Housem A.S.
275. Kuwait-Turkish Evkaf Finance House

U.A.E.
276. Abu Dhabi Islamic Bank
277. Dubai Islamic Bank
278. Islamic Arab Insurance Company
279. Islamic Investment Company of the Gulf, Sharjah
280. Social General

U.K.
281. Al-Baraka International Bank Limited
282. Al-Baraka Investment Company
283. Al-Rajhi Company for Islamic Investments

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284. Dallah Al-Baraka (Europe) Limited
285. First Interest-Free Finance Consortium
286. Islamic Finance House PLC (England)
287. Islamic Investment Banking Unit
288. Islamic Investment Company of U.K.
289. Masref Faysal Islamic Bank
290. United Bank of Kuwait PLS, London
291. Ummah Finance House

**U.S.A.**

292. Al-Baraka Bank Corporation Incorporated
293. BMI Finance and Investment Group
294. DMI Investment Services
295. Khidr Capital Corporation
296. Muslim Savings and Investment (MSI)
297. Takaful USA Management Services

**YEMEN**

298. Saba Islami Bank
299. Tadamun Islamic Bank
300. Yemen Islamic Bank for Finance and Investment

Source: 1. The International Association of Islamic Banks: *Directory of Islamic Banks and Financial Institutions 1997.*
APPENDIX 2

Financial Positions of Some Selected Banks

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Source: Resume of Activities of the Financial Institutions of Bangladesh, various issues.
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Source: Resume of Activities of the Financial Institutions of Bangladesh, various issues
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Source: Resume of Activities of the Financial Institutions of Bangladesh, various issues.
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Source: Resume of Activities of the Financial Institutions of Bangladesh, various issues.
GLOSSARY OF ARABIC TERMS

*ad’afan muda’afatan* – doubled and multiplied; a term used in the Qur’an (3:130) ordaining the believers not to devour *riba* or interest/usury doubled and multiplied.

*’adl* – justice, socioeconomic justice; antonym of *zu‘lma*.

*Allah* – the proper name of God as given in the Qur’an and the hadith.

*al-Fatihah* – the opening chapter; the first *surah* or chapter of the Qur’an.

*’aqida* – creed, doctrine, dogma; plural *aqi‘da*.

*awqaf* (plural of *waqf*) – tying up of the property in perpetuity so as to prevent it from becoming the property of a third person.

*bai‘ bi thaman ajil* – the terminology that is used sometimes (especially by the Islamic banks in Malaysia) for those forms of *murabahah/bai‘ muajjal* in which payment is made in instalments sometime after delivery of the underlying goods.

*bai‘ muajjal* – sale on a deferred payment basis, in lump sum or instalments, with or without a profit margin, as may be agreed between the buyer and the seller.

*bai‘ salam* – a contract for deferred delivery, mainly to facilitate the trading activities of farmers and generally for the production of raw materials and fungible goods.

*al-Baqarah* – the heifer, the second chapter of the Qur’an.

*barakah* – blessing, prosperity, abundant good; plural *baraka*.

*da‘if* – the weak *hadith*; the weak tradition which is not so reliable in terms of the degree of its defects in its reporters or in the text of the reports.

*fard* – a compulsory duty of a Muslim the omission of which is punished in hereafter.

*falih* – prosperity in the worldly life and success in the life after death; human well-being.

*faqih* (plural *fuqaha*’) – Muslim jurist; the authoritative judge of *shari‘ah*.

*fiqh* – *Muslim* jurisprudence based primarily on the Qur’an and the *sunnah* and secondarily on *ijma*‘ (consensus of the jurists) and *Qiyas* (deductive analogy) or *ijtihad* (scholarly reasoning).
gharar – any element of uncertainty or speculative risk in transactions not known to parties concerned in an agreement at the time of the contract.

hadith (ahadith) – A report on utterances, deeds or tacit approvals of Prophet Muhammad (pbuh); sometimes used as synonym of the sunnah.

halal – anything permitted by the shari'ah.

haram – an action which is forbidden and thus punished by Islamic law.

hasan – the good hadith; the fair tradition of the Prophet although inferior in the matter of authenticity to the sahih or authentic hadith.

hayah tayyibah – a life that is good and pure, happy life;

`ibadah (`ibadat) – worship of God; the divine laws that are related to religious practices and duties.

ijarah – hiring or leasing; technically, an exchange transaction in which a known benefit arising from a specific asset is made available in return for a payment.

ijarah wa iqtina – literally, ‘lease and ownership’; technically, a lease whereby the lessee derived economic use and ultimate ownership on the nature of a higher purchase.

ijma` – consensus of Muslim legal scholars on a legal issue after the death of Prophet Muhammad (pbuh).

ijtihad – exercise of one’s reasoning to arrive at a logical conclusion on a legal issue done by the jurists to deduce a conclusion as to the effectiveness of a legal precept in Islam.

`illah – underlying cause; the basis of laws.

`inan – limited investment partnership; one category of musharakah into which other than musawadah i.e., universal partnership, all types of partnership fall.

istikna` – a contractual agreement for specified made-to-order items, allowing cash payment in advance and future delivery, or a future payment and future delivery.

al-Jahiliyyah – the period in Arabia before the advent of Prophet Muhammad (pbuh); Pre-Islamic times.

ja’iz – an action which is permitted but is legally indifferent.

khalifah – man as vicegerent/trustee of God on earth.
makruh – an action which is disliked and disapproved by the shari‘ah but it is not under any penalty.

manihah – donation of usufruct; a productive asset granted to a needy person for specific period of time to enjoy its usufruct unreservedly.

mandub – an action is rewarded, but the omission is not punished.

mu‘amalat – the Islamic financial transactions.

mubah – same as jaiz, an action which is permitted but is legally indifferent.

mudarabah – a contract between at least two parties whereby one party, the financier entrusts funds to the other party, the entrepreneur, to undertake a business activity.

mudarib (‘amil) – the partner provides the entrepreneurship and management in the mudarabah form of partnership agreement between the financier and the entrepreneur.

mufawadah – same as musharakah was practiced by Prophet Muhammad (pbuh).

mujtahid – a Muslim jurist who derives Islamic ruling through scholarly reasoning on the basis of the Qur’an and the sunnah.

munakahat – the Islamic civil and family laws.

muqaradah – universal partnership; a kind of musharakah in which complete equality of investment and profit and loss is obligatory.

murabahah – sale an item with a fixed surcharge or profit added to the original cost.

musawamah – sale at a price mutually agreed upon by the buyer and the seller.

musharakah – a joint-venture agreement between two or more parties to engage in a specific business activity with an aim of making profit.

musharakah mutanaqqisah – diminishing partnership where invested funds are repaid over time as profitability allows.

mustahab – same as mandub, an action is rewarded, but the omission is not punished.

nama’ – to grow, to develop, to increase, flourish.

nisab – threshold; minimum level of income/wealth after which zakah is levied.

qard hasan – benevolent loan; a loan extended without any return.

qirad – same as mudarabah; this term is used by all schools of thought other than Hanafis.
qiyyas – deductive analogy through which a certain law on a certain issue is derived based on the Qur’an, the sunnah and the ijma’.

al-Qur’an – the Word of God revealed to Prophet Muhammad (pbuh) during his prophethood of about 23 years.

rab al-mal (sahib al-mal) – the partner provides the finance in the mudarabah form of partnership agreement between the financier and the entrepreneur.

rahn – a proof or something that has been held in pledge; holding something that has a value while giving something on debt.

riba – the term used in the Qur’an and sunnah to mean interest and/or usury; any pre-agreed excess paid/received over and above the principal in a loan contract. It is used in shari’ah in two senses: riba al-nasi’ah and riba al-fadl. (see for details below).

riba al-fadl – a sale transaction of the commodities (in which the injunction of riba is applicable) in which a commodity is exchanged for the same commodity but unequal in amount and the delivery of at least one commodity is postponed.

riba al-nasi’ah – refers to the increment/addition on the principal of a loan payable by the borrower to the lender in return for his ‘waiting’ as a condition for the loan; technically same as interest/usury.

salah – prayer; one of the five pillars of Islam.

shari’ah – the path believed by all Muslims to be the path shown by God through Prophet Muhammad (pbuh); divine law as given by the Qur’an and the sunnah.

sunnah – refers essentially to the practices, teachings and utterances of Prophet Muhammad (pbuh) other than the Qur’an.

ta’awun – cooperation, mutual assistance, working together.

takaful – scheme of mutual support and cooperation which provides insurance to individuals against any risk of falling into unexpected and dreadful need.

tawhid – the belief that God is one and he does not share anything with anybody, which is fundamental to Islam.

tawliyah – resale at original cost without profit or loss to the seller.

taharah – cleanliness, purity.

ummah al-Islam – Muslim nation; Islamic community.
`uqubat – the laws concerning Islamic punishments.

al-wadi'ah – a contract whereby a person leaves valuables as a trust for self-keeping.

wadi'ah – resale at a discount from the original cost; sale at a loss.

wajib – an obligatory duty of Muslims the omission of which is subject to punishment.

waqf – endowment; entailment; plural awqaf.

zakah – generic term for religious obligation of a Muslim’s sharing of his wealth or income with the poor and the needy, if it is equal to or above a certain minimum (nisab).

zulm – a comprehensive term used to refer to all kinds of injustice, inequity, oppression and exploitation that deprive others of their legitimate rights.
ISLAMIC BANKING IN BANGLADESH

by

Abu Umar Faruq Ahmad

A Thesis submitted in fulfillment of the requirement
for the degree of

Master of Laws (Honours)

University of Western Sydney
School of Law
April 2002
PLEASE NOTE

The greatest amount of care has been taken while scanning this thesis,

and the best possible result has been obtained.
ABSTRACT

This study is primarily concerned with the theory of Islamic banking and its practice in Bangladesh. As such, shari‘ah and its four sources (al-Qur’an, sunnah, ijma‘ and qiyyas) forming the basis of Islamic banking is discussed at length. Though the study is not a comparative study of Islamic and non-Islamic banks in Bangladesh, nonetheless, comparisons are made at places to shed more light on the practice of Islamic banking in Bangladesh. The objectives of the research are threefold: 1) to analyse the theoretical foundations of Islamic banking and practice in Bangladesh, 2) to examine areas of similarity and differences between the structure and practices of Islamic and conventional banks, and 3) to identify the problems, challenges and prospects of Islamic banking in Bangladesh. An insight into the experiences of Islamic banking in other countries around the world is also drawn.

The dissertation examines published primary and secondary sources including original Arabic sources. A general survey of existing literature on Islamic banking was undertaken, as well as fieldwork in Bangladesh to collect information on practices of Islamic banking in Bangladesh. The author draws heavily from his personal experience and involvement with the Shari‘ah Council of an Islamic Bank in Bangladesh.

The study is divided into six chapters preceded by an introductory chapter and followed by conclusions and recommendations. Chapter one covers an introduction to the study, its objectives, methodology, and significance of the research. Chapter two deals with the background to Islamic banking and its characteristic features as opposed to conventional banking. It also highlights the fundamental conceptual differences of Islam and capitalism concerning money and capital. The origins and history of riba or interest/usury is discussed from a theological and philosophical point of view to broaden understanding of the notion of interest. Chapter three deals with the four major sources of shari‘ah as the legal foundation of Islamic banking, and discusses the salient features of an Islamic economy and its relationship to Islamic banking. It also highlights the objectives and strategy of distributive justice from a shari‘ah perspective, and discusses the role of zakah in distributive justice. Chapter four focuses on shari‘ah principles for services,
products and the operation of Islamic banking. Chapter five critically analyses the issue of the prohibition of *riba*, which forms the foundation of Islamic banking and finance in the light of *al-Qur'an* and the *sunnah* - the two important sources of *shari'ah*. It also examines the controversy between the views of the Modernists and Conservatives on the definition of *riba* in these two major sources of *shari'ah*. Chapter six analyses the theoretical and practical aspects of Islamic banking by examining the existing literature on the subject. It also sheds light on the objectives and philosophy of Islamic banking. The chapter concludes by outlining the common problems and challenges faced by Islamic banking around the world. Chapter seven deals with the experience of Bangladesh in Islamic banking. It highlights some problems and prospects of Islamic banking in Bangladesh and makes some recommendations. Chapter eight concludes the findings of the research and offers certain submissions, observations and recommendations on this subject.

The study undertaken shows that over the years there has been an expansion of Islamic banking in Bangladesh. Islamic banks are competing successfully with their conventional counterparts in an environment where rules, regulations and regulatory bodies are designed to facilitate banking based on interest. At the same time it has become apparent that the profit and loss sharing framework which is one of the cardinal principles of Islamic banking, has yet to take deep root. The current profitability of Islamic banks is often maintained by products and services which on closer analysis resembles broadly the products of conventional banking. It is thus suggested that more in depth research should be undertaken by Islamic bankers and scholars to study products and services of conventional banking with a view to adapting them successfully to the tenets of *shari'ah*. 
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