



FACULTY OF LAW
University of Lund

Magnus von Schéele

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Supervisor
Katarina Olsson

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Contents

SUMMARY	1
PREFACE	4
ABBREVIATIONS	5
1 PREAMBLE	6
1.1 Introduction	6
1.2 Purpose, outline and delimitations	7
1.3 Materials	9
2 ISLAM AND THE SHARIA	10
2.1 Sharia	10
2.2 The role and significance of Islamic banking rules	12
3 HISTORY	15
4 RIBA	16
5 THE PHILOSOPHY OF ISLAMIC BANKING	18
5.1 The ideals	18
5.2 Speculation and excessive risk taking	21
5.3 Summary	23
6 DEPOSIT FACILITIES	24
6.1 Legislative conflict	24
6.2 Current accounts	25
6.3 Savings accounts	25
6.4 Investment accounts	27
6.5 Remarks	27

7	FINANCING FACILITIES	30
7.1	Investment financing (partnership financing)	31
7.1.1	Musharaka (equity participation contract)	31
7.1.2	Mudaraba	32
7.1.3	Economical consequences and business obstacles	33
7.1.4	Ethical issues	35
7.1.5	Problems with non-binding contracts	36
7.1.6	Supervision and control by the central bank	36
7.1.7	Summary	37
7.2	Trade financing	38
7.2.1	Murabaha (mark-up/commissioned purchase)	38
7.2.1.1	The model	38
7.2.1.2	Sources	39
7.2.2	Similarities with interest lending	39
7.2.2.1	Risk factor	39
7.2.2.2	Time-value	41
7.2.2.3	Delays in payment	41
7.2.2.4	A legal embarrassment	42
7.2.3	Innovative suggestions	44
7.2.4	Summary	45
7.3	Istisna (commissioned manufacture)	46
7.4	Lending	46
7.5	Government transactions	47
8	FINANCING OBSTACLES	48
8.1	Long-term projects	48
8.2	Small businesses	49
8.3	Running businesses	49
8.4	Government borrowing	50
8.5	Other related problems	52
8.6	Summary	53
9	THE SHARIA SUPERVISORY BOARD	55
9.1	Its function and responsibilities	55
9.2	The composition of the Board	57
10	CONCLUSIVE REMARKS	58
	BIBLIOGRAPHY	60
	TABLE OF CASES	66

Summary

The hub and main characteristic of Islamic banking is the prohibition of interest (riba), and this is the most significant difference between an Islamic bank and a conventional bank. The proscription has evolved from the stance that making money from money is unacceptable. Riba is often referred to as interest and usury, but it has often been disputed whether the expression involves both terms. Nevertheless, a majority of Muslim scholars and theologians now agree that the correct interpretation of riba is that interest and usury are one and the same. Interest must therefore at all times be condemned as usury.

Some countries claim to have converted their entire financial system to a wholly interest-free scheme. Other countries, like Malaysia, Saudi Arabia and Egypt employ a dual banking system where interest-based (conventional) banks may coexist with interest-free (Islamic) banks. Where dual structures are permitted more players are also commonly able to compete with the Islamic banks. This can be achieved by applying a concept of *Islamic windows*, where interest-based banks may offer Islamic banking methods in addition to its conventional banking services, hence allowing traditional western banks to participate in an Islamic banking system.

Islamic law (Sharia) also regulates the lawfulness of investments. A number of investments are considered to be Sharia-divergent, however not necessarily because of the proscription against interest (riba). For example, besides the prohibition to fund undertakings that engage in interest-based activities, the financing of projects that deal with gambling and alcohol are regarded as forbidden businesses also. As part of the gambling prohibition, trade in derivatives like options and warrants is also condemned.

The Islamic banking ideals are four-fold. First of all it is unacceptable to make money from money, constituting the first ideal. Subsequently there is a prohibition against riba. Secondly, there is the aim of a profit and loss sharing system, involving both the lender and the borrower. As a third element Islam prohibits gharar, meaning that business involving excessive uncertainty, risk or speculation shall be avoided. Finally there is the requirement that all investments must be halal, that is, permitted according to Islamic beliefs.

Islamic banks face difficulties in providing a competitive alternative to the saving account facilities that are being offered by conventional banks. First of all, returns are not always certain and secondly the nominal capital is not assured. Because of this, many Islamic banks do not abide by the Sharia laws, offering monthly rewards very similar to interest. In fact, in some countries where dual banking systems exist, e.g. in Malaysia, Islamic banks often present the best interest rates and do not even hesitate to call it by this name.

Another concern is that many Islamic banks, at variance with the Islamic law, often guarantee the capital value on savings- and investment deposits. For instance, until recently nearly all Islamic banks in Pakistan on a regular basis guaranteed its depositors the capital value.

Financing is perhaps the primary function of an Islamic bank. Between 50 and 80 percent of the total assets in Islamic banks are used for financing activities. Roughly, financing facilities can be categorised into three areas: investment, trade and lending. Different financing techniques are used to facilitate these areas, some are based on the PLS scheme, others on mark-up (commissioned purchase) and a few rely on benevolent loans.

In essence, there are two methods that dominate the concept of investment financing, both operating on a scheme where profits and losses are divided between the investor, respectively the entrepreneur. As a partnership funding principle, the musharaka technique to a large extent resembles a joint venture agreement. The investor, normally the bank, as well as the entrepreneur himself, both provide capital for the business enterprise and more often than not, both parties take part in the management. While losses are born in proportion to each party's capital contribution in the project, profits do not need to reflect the participation in the management nor does it need to mirror the financial inputs. It has been said that the musharaka instrument is the purest form of Islamic banking and the practice is supported by several verses in the Koran.

Profit- and loss-sharing financing has been put forward as an ethical banking method and is said to endorse shared responsibility. Meanwhile, critics are unconvinced about the concept's superiority, as dishonest clients may be tempted to exploit the PLS techniques by not disclosing the real profits. Moreover, there are obvious problems associated with the central banks' duties when it comes to supervision and control. The reason for this is that certain liquidity requirements need to be satisfied, but that it is rather problematic to determine the value of funds in an Islamic bank, especially if a large proportion of the assets consist of shares in various business projects and joint ventures. Additionally, there are apparent difficulties in evaluating the profitability of such enterprises, since returns are not guaranteed.

As a form of commissioned purchase, murabaha differs from the mudaraba and musharaka since the two latter are based on the PLS method, meanwhile the former refers to financing through a mark-up method.

Some commentators argue that commissioned purchase is not much different from conventional interest lending because the trade element of murabaha, in its original meaning, does not longer exist. Instead, the practice has been reduced to mere paperwork where the bank does not really take possession of the traded goods albeit this is a legal requirement. A related issue is that the bank may only seek compensation for its services if there is an evident risk associated with the transaction. Normally the merchandise is in the bank's possession only for half a second and it is well

questionable whether this is sufficient to support the utilization of the principle. Even the risk related to defects in the goods has been passed on to the clients, making them liable for any such shortcomings. Moreover, the use of time-value in dealings has been debated, because of its resemblance with interest-based lending.

Another problem is the adverse impact that the appliance of these principles may have on the relationship between the bank and the presumptive client. For instance, PLS financing in general has been claimed to be too costly, time demanding and uncertain.

Preface

Compiled in 2002, this thesis was produced during my six-month internship at the Swedish Ministry of Foreign Affairs, the Embassy of Sweden in Kuala Lumpur, Malaysia.

The subject matter of my work, Islamic banking, is a remarkably vital industry in Malaysia. In fact, Malaysia has been held to be the most frequent country in the world to employ the concept of Islamic banking. For that reason, but also as a result of my work at the Embassy, Malaysia has frequently been used as an example throughout the work.

One specific problem that I came across during my work was the difficulty in limiting the discussion to merely legal issues. Soon I realised that the thesis would not be complete without assessing religion, law and economics simultaneously. In many ways these matters are interconnected and a discussion on Islamic banking law would be pointless without analysing the economical consequences in connection with Islam.

As a final point, I would like to thank the Embassy of Sweden in Kuala Lumpur for their support during my work with my thesis. In particular, I would like to thank Mr. Johan Borgstam, the Deputy Head of Mission and H.E. Mr. Bruno Beijer, the Ambassador of Sweden in Kuala Lumpur.

Thank you

Magnus von Schéele
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Abbreviations

AAOIFI	Accounting and Auditing Association for Islamic Financial Institutions
BIB	Bahrain Islamic Bank
BIMB	Bank Islam Malaysia Berhad
CAMEL	Capital, Assets, Management, Earnings and Liquidity
GCC	Gulf Cooperation Council
IAIB	International Association of Islamic Banks
IBA	Islamic Banking Act (Malaysia)
IBM	Islamic Bank of Malaysia
IMF	International Monetary Fund
KLSE	Kuala Lumpur Stock Exchange
PLS	Profit and Loss Sharing
RCC	Regional Construction Company
RM	The Malaysian currency, Ringit (USD 1 = RM 3,8 - Sep. 27, 2002)
SSB	Sharia Supervisory Board
UN	United Nations
UNDP	United Nations Development Programme
USD	US Dollars

1 Preamble

1.1 Introduction

The hub and main characteristic of Islamic banking is the prohibition of interest (riba), and this is the most significant difference between an Islamic bank and a conventional bank.¹ The proscription has evolved from the stance that making money from money is unacceptable.² Riba is often referred to as interest and usury, but it has often been disputed whether the expression involves both terms. Nevertheless, a majority of Muslim scholars and theologians now agree that the correct interpretation of riba is that interest and usury are one and the same. Interest must therefore at all times be condemned as usury.³

Islamic banking is a fairly young concept evolving from a very old system of Islamic laws, the Sharia. The first attempt to establish an Islamic bank, based on an interest-free system, was in Malaysia during the mid-1940s.⁴ The project failed, but today Malaysian Islamic banking is considered as the benchmark in Islamic banking law. Islamic banks manage funds worth nearly USD 200 billion, which accounts for around 10% of the assets handled by banks worldwide.⁵ In view of the fact that Muslim banks only managed around USD 5 Billion in 1985, the concept of Islamic banking can be said to have grown remarkably during the last two decades, comprising banking activities in nearly one hundred countries worldwide.⁶ In Malaysia for example, Islamic banks alone hold funds of almost RM 52 billion (around USD 15 billion)⁷, confirming the country's importance in the Islamic banking community. Some experts even claim that Malaysia is the most frequent country in the world to employ the concept of Islamic banking.⁸ It is clear that the concept is of growing importance. During 1993 Islamic banks in Malaysia managed only RM 2.3 billion, growing to RM 29.9 billion in 1999.⁹ As stated above, this amount has almost doubled to RM 52 billion in 2001.

A key issue, and an important reason for this development in a global context, is the increasing number of players in the Islamic banking system. Some countries claim to have converted their entire financial system to a wholly interest-free scheme. Other countries, like Malaysia, Saudi Arabia

¹ Iqbal, p.42.

² Rahman, Dr. Yahia Abdul, p.14.

³ Haron & Shanmugam, p.45.

⁴ Ibid, p.5.

⁵ New Horizon, No. 107 "Muslim nations see growth in Islamic banking".

⁶ Iqbal, p.42; Haque & Mirakhor, IMF Working Paper (WP/98/54).

⁷ Sunbiz, 16 August, 2001, "Islamic banking assets at RM51.97b".

⁸ Interview with David Delfolie.

⁹ Rahman, Dato' Ahmad Tajudin Abdul.

and Egypt employ a dual banking system where interest-based (conventional) banks may coexist with interest-free (Islamic) banks. Where dual structures are permitted more players are also commonly able to compete with the Islamic banks. This can be achieved by applying a concept of *Islamic windows*, where interest-based banks may offer Islamic banking methods in addition to its conventional banking services, hence allowing traditional western banks to participate in an Islamic banking system.¹⁰

Another momentous reason for the increasing significance of the concept is the launching of new products. In Malaysia more than 40 products are offered, many of them relying on important principles like *mudaraba* and *musharaka*, both profit and loss sharing principles where the bank through a partnership agreement have shared interests, on one side, with a depositor, and on the other side with an entrepreneur.¹¹ In relation to this it should be pointed out that the concept of Islamic banking encourages financing methods through joint ventures between the lender and the borrower where profits and losses are shared. Finally there is a third important model called *murabaha*, which is a special form to finance the acquisition of goods via commissioned purchase.

Islamic law (Sharia) also regulates the lawfulness of investments. A number of investments are considered to be Sharia-divergent, however not necessarily because of the proscription against interest (*riba*). For example, besides the prohibition to fund undertakings that engage in interest-based activities, the financing of projects that deal with gambling and alcohol are regarded as forbidden businesses also. As part of the gambling prohibition trade in derivatives, such as options and warrants, is also condemned. These issues will be further discussed later on.

1.2 Purpose, outline and delimitations

As will be shown, there are many difficulties and contradictions associated with the application of Islamic banking law. It has been stated that Islamic banking law has adverse consequences to business entrepreneurship, but also to the economy in general. Moreover, it has been said that relevant Sharia laws have been circumvented, making the model not much different from conventional banking. The main focus in this work will be to highlight and evaluate these issues, but also other problem areas, such as supervision and legislative conflicts, will be assessed. All this will be done in connection to a methodical description of the concept of Islamic banking along with a clarification of the corresponding laws.

The descriptive part is essential for several reasons, but mainly because non-Muslims need to be given the opportunity to identify the relevant Islamic beliefs and the role of Sharia in order to understand the concept itself. This

¹⁰ Haron & Shanmugam, p.10 & 17.

¹¹ Sunbiz, 16 August, 2001, "Islamic banking assets at RM51.97b".

is because Islamic law does not consist of conventional sources of law such as paragraphs or case law, but of religious writings, sayings and customs. For that reason, the explanatory part is crucial to facilitate the reader with an understanding of the fundamentals. Moreover, most books on the subject of Islamic banking are written by Muslims who do not recognise the importance of objectivity. Therefore the aim has been to provide the reader with an impartial description of the Islamic banking model.

When assessing the problems and negations pointed at in the introduction, the focal point will be on the major and important principles mentioned in the beginning. Others will be clarified and referred to, but it is primarily the partnership models like *mudaraba* and *musharaka* and the principle of *murabaha* (commissioned purchase) that are of significance when evaluating these issues, largely because of their dominant function in Islamic banking.

Chapter 1 and 2 of this work will serve as an introduction on the topic of Islamic banking as well as on the religion of Islam. A brief clarification of Islamic law (*Sharia*) will also be given.

The remaining chapters deal with a more thorough discussion on the concept, practice and effects of Islamic banking law. Chapter 3 provides the reader with a historical background of Islamic banking law and in chapter 4 an assessment of the expression ‘*riba*’ will be made. In the subsequent chapter the philosophy of Islamic banking will be clarified by explaining the fundamentals of the concept. In chapter 6, the principal deposit facilities in Islamic banking are commented upon in conjunction with a methodical discussion on various related problems. Chapter 7 deals with the chief financing facilities, mainly investment and trade financing. Also assessing associated problems, chapter 7, along with chapter 8, makes up the essence of this work. Chapter 8 examines the effects on different types of businesses. Chapter 9 covers a presentation of the *Sharia* Supervisory Board and as a final note chapter 10 involves conclusive remarks and a discussion on contemporary Islamic banking and its future developments.

As an ancillary discipline Islamic insurance policy is sometimes mentioned in discussions involving Islamic finance. This work will solely deal with Islamic banking law and Islamic insurance law is not within the scope of this essay.

One shall not be confused if terms like *interest*, *riba* and *usury* appear to be used synonymously. As will be seen the words are in fact interchangeable when analysing the concept of Islamic banking.

In Islam, just like in many other religions, there are diverse opinions among religious scholars and schools as to the understanding of the religion. This also applies to the interpretation of Islamic banking law, but also how extensively the concept can be exploited. As a general rule, this work will rely on opinions held by the broader mass of Islamic experts and Islamic

banking specialists. Contrary views will be denoted, but these should be regarded as deviations from the broader rule.

Finally it should be brought to the reader's attention that there are many different spellings of Arabic words, mostly because of variations in the pronunciation.¹² Consequently, the Arabic words used in this particular essay might differ from spellings seen elsewhere.

1.3 Materials

Materials used in this work mainly consist of literature and articles, as well as publications and reports by the International Monetary Fund (IMF) and the United Nations (UN). One interview has been conducted and a number of major Internet resources on Islamic banking have been looked at. Case law on Islamic banking is very limited, i.e. only one court case can be found in Islamic banking literature, namely the Historic Judgement on Riba 23 December 1999 by The Shariah Appellate Bench of the Supreme Court of Pakistan.

As previously has been stated, many books on the topic of Islamic banking are written by Muslims. Unfortunately, a majority of them are also rather subjective in their approach. Critical views, mainly expressed in articles, as well as supportive opinions, have therefore been equally considered in order to ensure objectivity.

Being part of Islamic law (Sharia), Islamic banking is special in that way that it cannot be separated from religion - Islam is the law. Typically, the rules applicable to the concept of Islamic banking do not consist of conventional sources of law such as paragraphs or case law, but rather of principles referring to religious writings, sayings and customs. For that reason, it is difficult to refer to relevant legal sources. Reference will be given where this is appropriate, but most laws have developed during centuries of practice and tradition, so referring to legal sources would require proficient knowledge in the religion of Islam. Therefore specific reference cannot always be provided. One example of such a deviation is the principle of Murabaha (commissioned purchase), where direct reference cannot be found neither in the Koran nor in the Sunna.¹³ Still Murabaha is a part of Sharia and Islamic banking, comprising for over 75% of Islamic banks financing.¹⁴

¹² Haron & Shanmugam, p.82.

¹³ Saeed, p.77.

¹⁴ Ibid, p.95.

2 Islam and the Sharia

Comprising around 20 per cent of the world's population, Islam has established itself as the second largest religion in the world.¹⁵ Muslims are mainly spread over North Africa, the Middle East and South-East Asia. Although Islam originates from Saudi Arabia, non-Arab Muslims now outnumber Arab Muslims by a ratio of nearly three to one, which is also endorsed by the fact that the top four nations counting the largest number of Muslims in the world are all located outside the Middle East: Indonesia – 166 million, Pakistan – 111 million, Bangladesh – 97 million and India – 93 million.¹⁶ With the current reassertion of Islam the religion is of growing importance in an international context. In some countries there are clear tendencies towards an increasing use of Islamic law, also contributing to the mounting significance of the religion.¹⁷

Typically, Muslims are divided into two groups, often referred to as sects or traditions. Currently, around 80% of the world's Muslims are devoted to the Sunni tradition and approximately 15% are committed to the Shia movement.¹⁸ The main difference lies in their distinct preference as to the source of authority. The Sunni tradition says that an elected head of state shall govern Muslims, whereas the Shiites believe that the leader must be a descendant of the Prophet.¹⁹ As to the reading of the Koran, the interpretation among Shia Muslims may sometimes differ from the Sunni's traditional way of understanding. Also, the Shiites do not to the same extent as the Sunni Muslims, recognize the sayings and deeds by the Prophet (the Sunna) as a legal source.²⁰

2.1 Sharia

An oddity compared with western legal systems is that in the more conservative appearance of Islam there is no separation between the church and the state.²¹ Governmental law and religion are sometimes one and the same. The religious law of Islam is called the Sharia and is a comprehensive discipline regulating all public and private behaviour. The word itself, Sharia, literally means 'the path leading to the water'.²² The widespread understanding of this expression implies that Sharia must be described as

¹⁵ Halverson, p.103.

¹⁶ Ibid, p.103.

¹⁷ This was concluded already in 1988 by William Ballantyne, see Garret & Graham (editors), Introduction by William Ballantyne.

¹⁸ Halverson, p.105; Bogdan, p.224.

¹⁹ Analysis Malaysia, 4th issue, "Islamic jurisprudence: Various schools of thought".

²⁰ Halverson, p.105.

²¹ Wiechman, Kendall & Azarian.

²² Haron & Shanmugam, p.68.

‘the path to be followed’. Islamic law (Sharia) can be divided into two aspects, Ibadat and Muamalat. The former involves practicalities related to worship and Muamalat deals with man-to-man issues including political and economical relationships as well as social activities. Accordingly, as Islamic banking is an economical matter, it is channelled through the Muamalat aspect of the Sharia.²³

Another peculiar phenomenon in Islamic law is that besides classifying various actions or non-actions into forbidden and permitted behaviour there are two additional categories intended first of all for recommended conduct and secondly for reprehensive activities.²⁴ These deeds are not necessarily deemed as forbidden behaviour, but the ambition should be to comply with the recommended conduct or non-conduct. For example, in the Koran Muslims are discouraged from entering into any agreements or to close any deals Friday mornings since this is the foremost day for praying. However, an agreement entered into on this particular day is not null and void; also the contracting parties do not risk any reprisals due to the inappropriate choice of day.²⁵

There are four fundamental sources of Sharia law, the most important being the holy Koran, which is said to be Allah’s words presented to the Prophet. The Koran is the primary source; it is eternal and cannot be changed. The second element of Sharia law is the Sunna. The predominant meaning of the Sunna is that of the spoken and acted example of the Prophet. These examples have evolved into stories and anecdotes called Hadith, which were later, transmitted and put together. Simplified, these traditions can be said to constitute the Sunna.

Just like the Koran the Sunna is everlasting and cannot be altered. As a third foundation the Ijma is a consensus of opinions, interpretations given by religious scholars on a question of law. Qiyas is the last fundamental source of Sharia law and is a form of reasoning by analogy, a comparison with similar question already settled. Although Qiyas’ authority as the fourth element of Sharia law is not indisputable among the Sunni Muslims, they are still less reluctant to accept such interpretation than the Shiites. Between the Sunni schools of interpretation (Hanafi, Maliki, Shafi and Hanbali) it is mainly the Hanafis that have a profound reliance in Qiyas.²⁶ Also the Shafi’is recognize the employment of Qiyas, but are more conservative as regards the extent of the source, meanwhile the Hanbali school more often than not avoids any practice of analogy. Among the Shia Muslims Qiyas is not viewed upon as a legitimate source of Sharia law. In fact, the Jaferi school, the primary school of Shiites, totally rejects the usage.²⁷

²³ Ibid, p.69.

²⁴ Bogdan, p.222.

²⁵ Ibid.

²⁶ Report by ‘Centre for the strategic initiatives of women’, <http://csiw.org/Islam04.htm>

²⁷ Ibid, <http://csiw.org/Islam03.htm>

There are almost twenty nations that have acknowledged Islam in their constitutions.²⁸ Some of them refer to Islam as the only tolerable judicial system, e.g. Iran, meanwhile others, for instance Malaysia, make use of a dual or even multi system of laws.²⁹ This is also true on the topic of banking law structure, where Malaysia successfully applies a dual system with a complete range of choices.

Utilising a dual or multi legal system means that, for instance, either British common law, Hindu law or Islamic law may be applied to an identical situation depending on circumstances such as religious beliefs. In Malaysia special Sharia courts have been given jurisdiction over Muslims, comprising certain matters falling within civil law, e.g. family law. Even criminal law may come under the jurisdiction of a Malaysian Sharia Court, including offences of religious nature.³⁰ An essential feature is that the Sharia courts in Malaysia do not have jurisdiction where one of the parties involved is a non-Muslim; the case may then instead be brought before the civil court.³¹ For most Western jurists, however, this is a fact that is difficult to grasp, especially since the legal structure in many non-Muslim countries prohibits a system where one religion is favoured over another.³²

2.2 The role and significance of Islamic banking rules

As previously has been stated, Islamic banking is governed by the Islamic law (Sharia), but this does not necessarily mean that the concept falls within the jurisdiction of a Sharia court. In Malaysia for instance, Islamic banking cases are regarded as normal commercial disputes and any legal action taken on the subject of Islamic banking must be brought before a *civil* court and adjudicated under the principles of English common law.³³ Hence, the subject matter is rather considered as a civil law contract, enforceable in civil courts according to the contractual terms stipulated therein.

Typically, Islamic banking laws do not extend to the sphere of large systems of independent laws, but are instead more concerned with regulatory matters related to the forms of the business. This is also the situation in Malaysia, which is largely governed by the *Islamic banking Act 1983 (IBA)*. The IBA provides for the licensing of Islamic banks and the regulation of Islamic banking.³⁴ It does *not* provide any instructions for how Islamic banking principles should be carried out; such directives are to be found in the religious texts, for example, in the Koran and in the Sunna. It is important to note that the Malaysian IBA is under the jurisdiction of civil law, not

²⁸ Wiechman, Kendall & Azarian.

²⁹ Bogdan, p.229.

³⁰ Wu Min Aun, p.41-42.

³¹ Ibid, p.39.

³² Wiechman, Kendall & Azarian.

³³ Muhammad Hashim Kamali, p.258-259.

³⁴ Ibid; Islamic Banking Act (Malaysia) 1983, preamble.

Islamic law (Sharia). As soon as there is a conflict flanked by the two systems of laws, the common law will override the Islamic law.³⁵ Other areas, such as personal family law relating to succession, marriage, divorce etc, *do* however fall within the jurisdiction of the Islamic law, but only when it involves persons professing the religion of Islam (The Malaysian Federal Constitution, The Ninth Schedule, List II – State List).

Nearly all Muslim countries allow conventional banks to operate alongside Islamic banks. Besides Malaysia, also Egypt, Indonesia and the majority of the Gulf Cooperation Council countries (GCC) - The United Arab Emirates, Bahrain, Saudi Arabia, Qatar and Kuwait - make use of dual banking systems.³⁶ In Oman the Islamic banking model is forbidden all together.³⁷ Two Islamic states, Iran and Pakistan, differ in this meaning. The constitutions of these two countries require their entire banking systems to be fully compatible with Islamic law.³⁸ Also, unlike Malaysia for instance, Islamic banking in Iran and Pakistan *is* under the authority of the Sharia court and recently there was an important ruling by the Sharia Appellate Bench of the Supreme Court of Pakistan about the necessity of total consistency between the banking industry and the Islamic law.

The Sharia Appellate Bench of the Supreme Court of Pakistan declared that the entire banking system in Pakistan must be fully islamised, which according to the Court has not previously been the case even though it is stated as an explicit requirement in the constitution. The Pakistani constitution declares that any rules and laws that contravene the Islamic law of Sharia shall be rejected as null and void, and so, all banking transactions must be transformed into Sharia-based activities.³⁹ As a result the State Bank of Pakistan has formulated a new charter for Islamic banking under which Islamic banks will be set up.⁴⁰ Even in Iran, the banking industry has failed to fully comply with the Islamic law, but in a recent interview the Iranian Economic Affairs and Finance Minister Mazaher stated that the government is now trying to move towards an interest-free banking system in the true sense of the word with the aim of introducing proper Islamic banking.⁴¹ Today, in practice, guaranteed interest rates are set by the central

³⁵ New Straits Times (Malaysia), 17 Nov 1997, "Clear frame of law needed for Islamic banking".

³⁶ Iqbal, p.43.

³⁷ Financial Times, 13 Nov 2001, Survey: Site only – "Islamic banks are at the centre of a maelstrom despite little evidence that they have links to financing terrorism", by James Drummond.

³⁸ Iqbal, p.43.

³⁹ Business Recorder, 07 Feb 2002, "Banking with Islamic concepts".

⁴⁰ Business Recorder, 24 March 2002, "State Bank formulates new charter for Islamic banking", by Khalid Abbas Saif; Business Recorder, 07 Feb 2002, "Banking with Islamic concepts" – the deadline for the implementation of Sharia compliant banking under the Pakistani constitution was June 30, 2001.

⁴¹ BBC Monitoring Service UK, 15 May 2002, "Iran: The government to supervise non-government financial institutions".

bank of Iran.⁴² Finally, there is the Sudanese banking industry, which today is considered strictly Islamic.⁴³

Conclusively, it must be understood that regardless whether the courts are entrusted with the jurisdiction relating to Islamic banking, and regardless whether the domestic laws require (or do not require) Muslims to submit to the Islamic banking laws - a true Muslim shall, in any case, by his own free will, conform to this set of laws as they constitute a part of the Sharia. Consequently, and judging by the great number of Muslims spread throughout the world, the Islamic banking law is of significant importance. Furthermore, there is a growing desire among Muslims that to a greater extent act in consistency with the divine rules of Islam, constituting another important basis for the recent upsurge in Islamic banking and Islamic banking law.⁴⁴ So, although Islamic banking laws are not always expressed as explicit rules that need to be followed by every Muslim, and even if the concept more commonly is regarded as an option, this growing desire among many Muslims to abide by the Sharia law is a key reason why Islamic banking law today is remarkably essential and even of growing significance.

⁴² Financial Times, 13 Nov 2001, Survey: Site only – “Banks convert to competition Islamic banking is seen as a means to rid the state bank sector of its inefficiencies”, by Guy Dinmore.

⁴³ Financial Times, 08 Oct 2001, “ATTACK ON AFGHANISTAN: Islamic banks stung by claims they fund violent extremists”, by James Drummond.

⁴⁴ Iqbal, p.42.

3 History

The first modern experiment involving Islamic banking activities was in Egypt during the 1960's.⁴⁵ Established as an interest-free banking alternative, the bank mainly focused on providing savings facilities based on the profit and loss sharing concept, often referred to as the *PLS scheme*. However, in order to avoid being viewed as an experiment conducted by Islamic fundamentalist, the pioneer himself, Ahmad El Najjar, decided not to proclaim the banks Islamic. The experiment continued until 1967, by which time there were nine such banks.

A few years later, in 1971, the Nasir Social bank was established in Egypt and declared as an interest-free commercial bank, but still no allusion to Islamic law (Sharia) was made.⁴⁶

The first successful attempt to establish an Islamic bank was made in Malaysia 1983. Previous efforts had been made in the country as early as the 1940's, but did not turn out to be the immediate success as was anticipated.⁴⁷ In the aftermaths of the successive launch of the Islamic banking concept during the early 1980's, Bank Islam Malaysia Berhad (BIMB) emerged as a full-fledged commercial bank based on Sharia rules.⁴⁸ Today BIMB is regarded as one of the leading Islamic financial institutions in Malaysia and is believed to have been, and still, to be, an important player and reason for the establishment and development of Islamic banking services in Malaysia.

Even if the Islamic banking concept is more frequently used in regions and countries where Islamic influences are more profound, Islamic banks can today be found throughout the whole world, also in non-Muslim communities, e.g. in Copenhagen (Islamic Bank International of Denmark) and in Melbourne, Australia.

⁴⁵ Islamicity, Finance Information Center,
http://islamicity.com/finance/IslamicBanking_Evolution.htm

⁴⁶ Ibid.

⁴⁷ Haron & Shanmugam, p.5.

⁴⁸ Islamicity, Finance Information Center,
http://islamicity.com/finance/IslamicBanking_Evolution.htm

4 Riba

As has been said previously the main characteristic of Islamic banking is the prohibition of interest (riba). Literally, riba means increase⁴⁹, but the Prophet never explained the real meaning of riba. As a consequence there have been disagreements as regards the essence of the term. Riba is damned for being usury, even though a small minority of Muslim scholars still say that loans and debts should be excluded from the prohibition. Attempts have even been made to distinguish between loans intended for consumption and loans meant for production.

Even among those religious scholars who *do* believe that the riba prohibition involves lending and borrowing activities, that is to say the majority of Muslim scholars, there are disagreements whether interest *always* constitutes usury. In Egypt for example, interest is permitted to a certain extent. If the interest imposed on the borrower exceeds what is regarded as a normal increase on a loan, only then is it considered as an unlawful act of usury.⁵⁰ This argument is sought to be sustained by verse 3:130 in the Koran, which states: “O ye who believe! Devour not Usury, doubled and multiplied: but fear Allah: that ye may (really) prosper.” The broad mass however considers riba, in any form, as usury. In fact, in its verdict the Sharia Appellate Bench of the Supreme Court of Pakistan explicitly stated that “doubled and multiplied” is not a necessary condition since verse 2:278 says: “O those who believe fear Allah and give up whatever remains of riba, if you are believers.” The phrase “give up whatever remains of riba” therefore implies that every amount over and above the principal sum has to be given up.⁵¹ All the same, the real meaning of riba is, as has been denoted above, still unknown as the Prophet never clarified the true essence of the term. The actuality that riba literally means increase, does however support the stance taken by the Court, that every increase on a loan, imposed by employing a certain rate of interest, is prohibited. As a majority opinion among Muslim scholars this will also be the standpoint in the subsequent analysis of Islamic banking. According to the Sunna the Prophet stated that all riba contracts are illegitimate and void.⁵² All Muslims are discouraged from involving themselves in debt.⁵³

By pointing to the fact that also Judaism, Christianity and Hinduism have condemned usury, various Muslim scholars argue that the prohibition

⁴⁹ Rahman, Dr. Yahia Abdul, p.115.

⁵⁰ Saeed, p.46.

⁵¹ The Sharia Appellate Bench of the Supreme Court of Pakistan, “The text of the Historic Judgement on Riba 23 December 1999”, p.53-55.

⁵² Saeed, p.30.

⁵³ Ibid, p.126.

against interest is not a purely Islamic idea.⁵⁴ In the Bible, Ezekiel 18:8.9, it says “He hath not given forth upon usury, neither hath taken any increase...he is just. He shall surely live, said the Lord God.”

In Islam there are conflicting opinions among the four major Sunni schools of interpretation as regards the magnitude of the riba (interest) prohibition pertaining to business between Muslims and non-Muslims. The Hanafi school maintains that Muslims are allowed to trade on the basis of riba as long as their business is carried out on non-Islamic territory and on the condition that their counterpart is a non-Muslim. Also, they allow interest-based trading with converted Muslims from non-Muslim countries.⁵⁵ All the same, the majority of Sunni scholars and the three remaining Sunni schools of jurisprudence reject any employment of riba, regardless with whom trade is conducted. Nevertheless, just like the Hanafis, the Shia Muslims regard interest-based transactions with non-Muslims legitimate, but only with reference to accepting riba, not awarding it.⁵⁶ It should be noted that in essence, Shia laws do not differ significantly from the Sunni practice of Islamic banking.⁵⁷

⁵⁴ Business Recorder, 24 April 2000, “40 countries have Islamic banking window, says Pervez Said”; New Horizon, No. 110, July 2001, “Eliminating interest from the Economy”, by Muhammad Akram Khan.

⁵⁵ Haron & Shanmugam, p.63.

⁵⁶ Ibid, p.63.

⁵⁷ Financial Times, 26 Oct 2000, Survey – “Association sets new standards – Islamic banks have a long history of exposure to bad risks and the need for consistency is paramount”, by James Drummond.

5 The philosophy of Islamic banking

5.1 The ideals

There are several elements that contribute to the Islamic banking philosophy, but the most important is unmistakably the elimination of usury.⁵⁸ Transactions where money reproduce and give birth to more money are banned in Islam, some say because it is considered as an ‘unearned income’. Only production and trading shall generate economic activity.⁵⁹ This principle forms the basics of the Islamic banking philosophy and is one of the reasons why paying and accepting interest (riba) is prohibited in Islam. In the Koran verse 2:275, interest (usury) is strongly condemned: “Those who devour usury will not stand except as stands one whom the Evil one by his touch has driven to madness. That is because they say: ‘Trade is like usury’. But Allah hath permitted trade and forbidden usury.” And in verse 4:161 the consequences of charging interest are stated: “That they took usury, though they were forbidden, and they devoured men’s subsistence wrongfully; We have prepared for those among them who reject faith a grievous punishment.”

By quoting the renowned jurist and philosopher of Islamic history, Imam Al-Ghazzali, the Sharia Appellate Bench of the Supreme Court of Pakistan, in its judgement on riba, acknowledged why interest is considered detrimental in Islam.⁶⁰ Imam Al-Ghazzali said: “*Riba* (interest) is prohibited because it prevents people from undertaking real economic activities. This is because when a person having money is allowed to earn more money on the basis of interest...it becomes easy for him to earn without bothering himself to take pains in real economic activities. This leads to hampering the real interests of the humanity, because the interests of the humanity cannot be safeguarded without real trade skills, industry and construction.”

The institute of Islamic banking and insurance claims there are several reasons why interest is undesirable.⁶¹ They say it is immoral and clearly against Islamic norms to demand interest from a borrower if the enterprise generates less profit than the amount, which is due as payment for interest. Also, they argue, an interest-based system discourages innovation by small businesses, as these, unlike large businesses, do not have the necessary funds for further development. Instead, to avoid such immoral banking methods and to encourage e.g. small business enterprising, Muslim jurists support a financing system based on a profit- and loss-sharing (PLS) scheme, where both the bank and the borrower shall share the risks and the

⁵⁸ Iqbal, p.42.

⁵⁹ Rahman, Dr. Yahia Abdul, p.14.

⁶⁰ The Sharia Appellate Bench of the Supreme Court of Pakistan, “The text of the Historic Judgement on Riba 23 December 1999”, p.88-89.

⁶¹ IIBI, http://www.islamic-banking.com/shariah/sr_bf.php

rewards of financing a business venture.⁶² Hence, good Muslims should not deal in interest, but instead join in mutual projects, where the lender and borrower share incomes and deficits. Whether an Islamic banking system in reality encourages small business enterprising is however questionable. This matter will be assessed in chapter 8.2.

Verse 30:39 in the Koran says: “That which ye lay out for increase through property of (other) people, will have no increase with Allah...” This verse, among several others, comprises the general consensus among Muslim scholars, that interest is a forbidden element, as it constitutes unjustified earnings. As an objection to such opinions and in view of the fact that rental fee on property is regarded to be lawful earnings in Islamic law, many critics consider the prohibition both illogical and absurd. Supporters of the prohibition reject the analogy, claiming that the benefit to the tenant is certain, but as regards money lending it is often tentative whether the client will benefit from the money he has borrowed if the funds e.g. are going to be used for investment purposes.⁶³ But even if the borrowed money would be deposited in a conventional banking account with a definite, fixed interest rate where nominal value is guaranteed, and hence the benefit to the client *is* certain, the *riba* prohibition applies. This is clearly inconsistent with the above arguments put forward by supporters of the prohibition.

Spending money for the welfare of the people and not on wasteful pleasure is another important element in Islamic banking philosophy. Over-consumption is not allowed and in verse 4:36 the Koran says: “They ask thee concerning wine and gambling. Say, ‘In them is great sin, and some profit, for men; but the sin is greater than profit.’”

A related issue in this reading is the saying that no profit shall be made without the benefit of the community. Accumulation of wealth shall not be an aim, whereas sharing should.⁶⁴ In agreement with the Sharia rules the best method in accumulating wealth refers back to the basics of Islamic banking philosophy, that is, it should not be generated by other people’s efforts, but on one’s own.⁶⁵ This element of sharing responsibility can be traced back to the roots of Islamic banking.⁶⁶ Not only individuals, but also Islamic banks are expected to see to the needs of the society, to promote social welfare activities and to give more assistance to the needy and the poor.⁶⁷ But this doesn’t mean that wealth is condemned. On the contrary, wealth is often viewed as a positive good, as long as a proportion of it is left

⁶² Nida’ul Islam magazine (<http://www.islam.org.au>), “Principles of Islamic banking”, published at <http://www.islam.org.au/articles/older/BANKING.HTM>

⁶³ Islamicity, Finance Information Center, http://islamicity.com/finance/IslamicBanking_Rationale.htm

⁶⁴ Haron & Shanmugam, p.34.

⁶⁵ Ibid, p.40.

⁶⁶ Ibid, p.34.

⁶⁷ Ibid, p.34.

for the community and those that are less fortunate.⁶⁸ In the Koran verse 2:276 it says: “Allah will deprive usury of all blessing, but will give increase for deeds of charity; For he loveth not creatures ungrateful and wicked.” Some Muslims have interpreted this requirement as if it could be fulfilled through tax payments. Clearly, this is a misconception; because besides the standard tax payments Muslims should also be willing to give away additional funds, by their own free will. Ironically, this obligation is repeatedly ignored in Saudi-Arabia, where Sharia is often strictly applied. And in Malaysia, which is perhaps the most liberal Islamic state, followers of the religion appear to be remarkably willing to make contributions to the poor and needy.⁶⁹

Furthermore, verse 4:36 in the Koran spells out that alcohol consumption and gambling activities are illegal. This is also confirmed by verse 5:91 in the Koran, saying: “The Satan definitely intends to inculcate enmity and hatred between you by means of liquor and gambling, and wants to prevent you from remembering Allah. So would you not desist?” As a result the prohibition also confines the freedom of investment. Any involvement in business enterprises must be halal (permitted). An unlawful investment is for example every business that involves obscenity, prostitution and adultery. The manufacture, sale and even the transportation of alcohol are also illegitimate. Another offence is the making and sale of idols, as are fortune telling, gambling, and of course, any business that involves riba.⁷⁰ Normally, the insurance industry is deemed usurious and for various reasons investors are also forbidden to hold stakes in companies whose core activities are defence or entertainment.⁷¹ Because of these restrictions, and especially as Muslims are not allowed to invest in businesses dealing in interest, Islamic mutual- and equity funds have lately performed very badly. This, since investments in interest-generating funds usually function as a haven for traditional investors when stock market indices fall.⁷²

Problems also arise when the main business line is Sharia-compliant, but a minor part of the profits originates from non-halal (forbidden) activities. How strict shall one be when assessing the suitability of such an undertaking? For instance, an airline company that serves alcohol and pork-related products on its flights may fall within this category. By utilising a method of *purification* or *dividend cleansing* religious scholars have found a way to get around this dilemma.⁷³ As, where a business involves interest-based activities, Islamic banking experts normally decide on a 25 per cent threshold, which will allow Muslim investors to invest in the business if not

⁶⁸ Vogel & Haves, p.291.

⁶⁹ Interview with David Delfolie.

⁷⁰ Haron & Shanmugam, p.42.

⁷¹ Financial Times, 29 May 2002, “GLOBAL INVESTING: Lack of experts threatens Islamic investing”, by Fahrhan Bokhari.

⁷² Dagens Industri, 10 Aug 2002, “Tuffa tider för muslimska fonder”.

⁷³ Financial Times, 13 Nov 2001, “Survey: Site only – “Room for manoeuvre on the equities front - Like ethical funds, there is some side-stepping involved in finding shares that conform to the appropriate ethical standards”, by Lydia Adetunji.

more than 25 per cent of the total income of the firm is generated through interest-lending activities. Such an investment does however require the investors to cast off the interest-based proportion for the benefit of the needy, for instance by allocating that particular part for public charity.⁷⁴ Other obvious illegal businesses include dealing in pig farms and drugs. Numerous Muslim scholars also consider dealing in tobacco products to be at variance with the Sharia. All of the aforementioned restrictions apply to every type of investment, even investments on the stock market.

Seeing the increasing number of Muslims that require their investments to be halal (permitted), also the governments in various Islamic states have had to evaluate whether their own activities are in accordance with the Sharia. Malaysian pension funds for instance are now selling its gaming and brewery shares because of this.⁷⁵

5.2 Speculation and excessive risk taking

Next to the prohibition of riba, the unlawfulness of gharar (excessive risk taking) is perhaps the most significant restriction in Islamic banking when discussing finance and investments. Not only does the expression comprise pure gambling, but also other kind of risks and hazards.⁷⁶ Muslim scholars claim that the proscription against excessive risk-taking will benefit economic stability. When reading the Sunna it is clear that all transactions involving gharar are forbidden. Since owning shares might appear as a hazardous adventure, involving both risk and speculation, the question whether owning shares, in itself, is halal (legitimate) may arise. This has been commented upon by the *Institute of Islamic Banking and Insurance*, which supports the view of permissiveness. It is clear they say, that owning shares is justifiable as long as the business you are investing in and its earnings are halal.⁷⁷ Others have also come to this conclusion.⁷⁸ Partnership and entrepreneurship are encouraged in Islam, and since buying a share in reality means that the investor acquires an equity interest and becomes an actual partner in the business, investing in shares is considered to be a proper use of money. This is a major difference compared with trading in derivatives, e.g. options, that only involves intangible rights, giving it a more speculative appearance.

⁷⁴ Islamicity, Finance Information Center,
<http://islamicity.com/finance/UnlawfulBusiness.htm>

⁷⁵ New Horizon, No. 115, Dec/Jan 2002, "Malaysia Pension Fund To Sell Gaming, Brewery Shares".

⁷⁶ Vogel & Haves, p.64.

⁷⁷ http://www.islamic-banking.com/shariah/sr_bf.php.

⁷⁸ New Horizon, No. 107, March 2001, "Shariah Questions – Validity of shares".

A number of the major stock exchange indices, like the American Dow Jones and the UK-based FTSE⁷⁹ International, have set up Islamic investment markets, where halal-shares can be traded. Bankers sometimes say that these markets are quite similar to ethical investing as these Islamic indices aim to only include stocks that are good for the society. Today, the Dow Jones Islamic index consists of more than 600 listed companies.

Since derivatives easily can be used for gambling, trading in warrants and options is generally forbidden. But the gambling aspect is not the only reason for this. Other motives are that Islam does not approve payment for a mere intangible right, because this is not regarded as property in a typical sense. Also, derivatives may involve the right to sell what one does not own and this as well violates the Sharia.⁸⁰ Yet, some scholars claim that there is no apparent conflict between the usage of these derivatives and Sharia law.⁸¹

Even though options and warrants could be used for gambling they are most of all instruments used for risk protection. An option may for example be used as protection against extreme currency fluctuations. It could also work as a guarantee or insurance in case a costly project fails. Third-party-guarantees do offer some risk protection, but in Islam they are all subject to various limitations.⁸² So even if a number of Islamic banks claim that there are alternatives, no effective derivatives for risk hedging can be said to exist, which of course is a dilemma for companies seeking stability.⁸³

So, when assessing whether an investment on the financial market is in accordance with the Sharia law, two questions must be scrutinized. First of all, will the acquiring of the instrument make participation in the business *possible*, seeing it as a sincere partnership investment, not only as a hazardous short term investment? This is what separates shares from derivatives. Secondly, are the business activities halal? The answer to this question excludes any trading in e.g. alcohol and interest rates.

By this, it is clear that speculation is opposed, and in contrast, business is encouraged. However it is easy to sense a tad of double moral, because even if shares make the possessor an actual partner in the company, very few shareholders participate in the business. Instead many investors deal in shares on an every day basis, buying and selling the same shares several times per day. In these cases many would claim that such activities are pure speculation without any intention to remain in a productive and fruitful partnership. Dr. Yahia Abdul Rahman, a writer on Islamic banking, has

⁷⁹ Financial Times, 13 Nov 2001, "Survey: Site only – "Room for manoeuvre on the equities front - Like ethical funds, there is some side-stepping involved in finding shares that conform to the appropriate ethical standards", by Lydia Adetunji.

⁸⁰ Vogel & Haves, p.164-165.

⁸¹ Haron & Shanmugam, p.181.

⁸² Vogel & Haves, p.232.

⁸³ Ibid, p.231.

uttered:⁸⁴ “...computerization of stock markets throughout the world has blurred the distinction between investment and speculation. The entire system is moving towards becoming a huge worldwide gambling casino with no pretension to serving social needs.” It is clear that such speculative transactions lack the need for a genuine partner- or entrepreneurship. Only little support can then be given to views that the prohibition against provides for economic stability.⁸⁵

5.3 Summary

To summarise what has been said in this chapter, the Islamic banking ideals are four-fold. First of all it is unacceptable to make money from money, constituting the first ideal. Subsequently there is a prohibition against riba. Secondly, there is the aim of a profit and loss sharing system, involving both the lender and the borrower. As a third element Islam prohibits gharar, meaning that business involving excessive uncertainty, risk or speculation shall be avoided. Finally there is the requirement that all investments must be halal, that is, permitted according to Islamic beliefs.

⁸⁴ Rahman, Dr. Yahia Abdul, p.31.

⁸⁵ Compare with the statement made by Imtiaz Alam Hanfi, chairman of the Commission for Transformation of Financial systems in the State Bank of Pakistan (New Horizon, No. 108, April 2001, “Islamic nations pledge to press ahead with developing banking”), where he emphasizes that stability requires genuine entrepreneurship.

6 Deposit facilities

Just like conventional banks Islamic banks are dependant on their depositors' money as a major source of funds, but unlike conventional banks the Islamic banks are not allowed to guarantee any rate of return on the basis of interest.⁸⁶ Moreover, a number of Islamic banks cannot even guarantee the nominal value of the deposits, because they are reliant upon the profit- and loss-sharing scheme. This characteristic mainly applies to investment accounts, but in most cases also savings accounts.⁸⁷

6.1 Legislative conflict

In those cases where no capital guarantee exists it clearly constitutes a fundamental difference from Western banking. As a result it may be difficult for Islamic banks to be granted permission to operate in countries working under conventional banking laws. This dilemma has been highlighted in the United Kingdom where Sir Leigh Pemberton, the previous Governor of the Bank of England, has expressed anxiety regarding this matter. What he implied was roughly that it “is important not to risk misleading and confusing the general public by allowing two essentially different banking systems to operate parallel...a central feature of the banking system of the United Kingdom as enshrined in the legal framework is capital certainty for depositors. It is the most important feature, which distinguished the banking sector from the other segments of the financial system...the Bank of England is not legally able to authorise under the Banking Act, an institution which does not take deposits as defined under that Act.”⁸⁸ This is where the apparent legislative conflict lies when setting up a riba-free bank in an interest-based banking community. A different approach would be to offer non-guarantee deposit facilities without using a banking name, but that is of course a less appealing alternative, mainly because clients will then be more reluctant to deposit their money.

⁸⁶ Gafoor, p.61.

⁸⁷ Ibid, p.42.

⁸⁸ Statements made by Sir Leigh Pemberton, summarised by A.L.M. Abdul Gafoor, Gafoor, p.61-62.

6.2 Current accounts

This facility, also known as demand deposit, is virtually the same as in all conventional banking. Demand deposits are deposits kept for safekeeping and offer easy accessibility to funds for transaction purposes, for instance to write cheques on the account. Normally no returns are provided for deposits in current accounts, in fact it is more likely that the bank will impose a modest fee for its services. Nevertheless, in Malaysia most banks *do* award returns for current account deposits, on condition that certain requirements are fulfilled.⁸⁹ Bank Islam Malaysia allows such returns, offering gifts to clients who deposit their money in current accounts. In April 2002 the profit rate (compare ‘interest rate’) for current account deposits in Bank Islam Malaysia was set at 0.2% for funds below RM 25,000 (approx. USD 6,500).⁹⁰ However, Islamic banks still rarely offer returns for current account deposits.

Another important characteristic, which, in contrast to capital returns, at all times is assured by the Islamic banks, is the capital value.

Typically, two Sharia principles can form the basis of current account facilities. *Quard hassan* is one and literally means good loan or loan without interest.⁹¹ Having a current account under the principle of *quard hassan* generally means that all money paid to the client’s bank account will be considered as a loan given to the bank. The bank may use these funds freely (at its own risk) and do not need to give any rewards to the depositor.⁹²

The second principle is called *wadiah* and is widely used by Islamic banks in Bangladesh, Jordan and Malaysia. When the *wadiah* principle is used the money will be deposited for safe custody and is not referred to as a loan. Unlike *quard hassan*, *wadiah* requires that the bank seeks permission from its client to use the funds at the bank’s own risk.

A shared feature is however that both *quard hassan* and *wadiah* deposits give its owner the right to a part or to the whole of the deposits at any time they so desire. The bank guarantees this.

6.3 Savings accounts

In contrast to the current accounts, deposits in savings accounts are not merely done for safe keeping or easy accessibility, but as the name suggests, for saving purposes. The fund owners deposit their money because they want their capital to grow, hence they expect returns.

As they expect an increase to their deposits and since interest is forbidden, returns must be realised by means of profit- and loss-sharing (PLS)

⁸⁹ Haron & Shanmugam, p.92.

⁹⁰ BIMB, http://www.bankislam.com.my/kadar_deposit_e.htm

⁹¹ Vogel & Haves, p.302.

⁹² Haron & Shanmugam, p.94.

principles.⁹³ This can be done through the PLS partnership of *mudaraba*.⁹⁴ However, since returns must be realised using the PLS-scheme, capital cannot be guaranteed for such deposits.

Nevertheless, and even though the practice has been heavily criticised by a number of Muslim scholars, some Islamic banks do provide capital-guaranteed savings accounts that are based on non-PLS principles like *quard hassan* and *wadiah*. While the clients anticipate returns on their savings these banks offer monthly rewards like cars, air tickets and other goods to its customers. In Malaysia monthly rewards on *wadiah* deposits are even paid in cash in the form of rates of profit announced by the bank.⁹⁵ Bank Islam Malaysia has a standard formula to calculate this monthly reward.⁹⁶

$$\frac{\text{CDB for the month}}{\text{Number of days in the month}} \times R \times \frac{1}{12}$$

CDB : Cumulative daily balance in the savings account
R : Rate of profit given at the end of month

As stated above, this system where Islamic banks offer returns for non-PLS deposits has been heavily criticised by Muslim scholars. They claim that such rewards, done on a *regular* basis without sharing the risks of a partnership, constitutes a form of *riba* very similar to conventional banking. The Sharia supervisory board (SSB) of the Faisal Islamic Bank of Sudan has also taken this position.⁹⁷ The function and responsibilities of the Sharia supervisory board will be further discussed in chapter 9.

When referring back to the basic philosophy of Islamic banking, that money shall not reproduce money, it is clear that the only permissible method to operate a savings account that generates returns is through PLS partnership methods, like *mudaraba*. In such a partnership arrangement the client contributes with the capital and the bank acts as the entrepreneur, assorting the funds into various low risk business activities. The profits will be shared on a predetermined ratio, but if business fails the entire loss will be born by the customer.⁹⁸ This, as a concrete example, gives additional strength to arguments that the absence of capital guarantee in savings accounts is a

⁹³ In July 2002 Bank Islam Malaysia offered profit rates (returns) amounting to 2.34 per cent for PLS-based *mudaraba* savings account deposits.

⁹⁴ The principle of *mudaraba* can be employed not only for savings accounts, but also for investment purposes and even as a financing method. As will be shown later on, the context in which the principle is utilized may result in a different appliance of the model.

⁹⁵ In July 2002 returns for deposits made to *wadiah* savings accounts at Bank Islam Malaysia were set at 1.9 per cent.

⁹⁶ Haron & Shanmugam, p.99.

⁹⁷ *Ibid*, p.97.

⁹⁸ *Ibid*, p.98.

major obstacle for Islamic banks aiming to operate in non-Muslim countries. The inconsistency with conventional banking law requirements is obvious.

In the end the *practising* Muslim will be left with only two inadequate alternatives. Either he can deposit his assets in a current account, without returns. Or he can leave his money in a savings account with possibility of returns, but devoid of nominal capital guarantee.

6.4 Investment accounts

These accounts can be looked upon in the same way as savings deposits, but in contrast to the latter, investment accounts are not for saving purposes, but focus on customers who want to invest.⁹⁹ All investment deposits available at Islamic banks are governed by the profit and loss sharing (PLS) principle of Mudaraba. Usually, customers invest their money for a certain period of time and any profit or loss will be shared with the bank.¹⁰⁰ The only contractual agreement between the depositor and the bank is the profit ratio, which will determine how the profits or losses are to be distributed.¹⁰¹ As one Islamic bank may employ a different profit ratio than other Islamic banks, no prevailing method of sharing the profits can be said to exist. In Maybank for instance, profits are equally shared, meanwhile Bank Islam Malaysia utilises a 70:30 ratio, of which 70 per cent is payable to the investor, while the remaining 30 stays with the bank.¹⁰² The risks are greater than those comprising savings accounts and the objectives of the concept very much resemble those of a mutual stock market fund.

6.5 Remarks

Clearly, Islamic banks face difficulties in providing a competitive alternative to the saving account facilities that are being offered by conventional banks. First of all, returns are not always certain and secondly the nominal capital is not assured. Because of this, many Islamic banks do not abide by the Sharia laws, offering monthly rewards very similar to interest. In fact, in some countries where dual banking systems exist, e.g. in Malaysia, Islamic banks often present the best interest rates and do not even hesitate to call it by this name.¹⁰³

Another concern is that many Islamic banks, at variance with the Islamic law, often guarantee the capital value on savings- and investment deposits. For instance, until recently nearly all Islamic banks in Pakistan on a regular

⁹⁹ Rahman, Dr. Yahia Abdul, p.93.

¹⁰⁰ Haron & Shanmugam, p.100.

¹⁰¹ Errico & Farahbaksh, IMF Working Paper (WP/98/30).

¹⁰² All figures as of 8 July 2002.

¹⁰³ Interview with David Delfolie.

basis guaranteed its depositors the capital value by means of assured rates of returns “for the simple reason that no bank could afford to declare a loss in its deposits and thus cause a run on itself.”¹⁰⁴ This even applied to investment accounts where the profit and loss sharing (PLS) scheme had been utilised, opposing the Islamic beliefs since losses, according to the Sharia, ought to be shared between the bank and depositor. Following the verdict by the Sharia Appellate Bench of the Supreme Court of Pakistan these kinds of practices are now likely to cease. In point of fact, and contrary to opinions among Western critics that the capital guarantee is a crucial and necessary element in a banking system, the Sharia Appellate Bench of the Supreme Court of Pakistan has argued that an Islamic bank would never make use of its clients’ savings- and investment account deposits without due care and attention and that “the possibility of loss to the whole portfolio is merely a theoretical possibility which should not discourage the depositors.”¹⁰⁵ This, they claim, is because before reinvesting the clients’ money the bank will carefully assess the feasibility of the proposed business. However, it is doubtful whether depositors will find this very convincing, especially bearing in mind the collapse of the Abu Dhabi-based Bank of Credit and Commerce International and the recent rescue of Dubai Islamic in 1998 after a massive fraud came to light. Islamic banks have a long history of exposure to bad debts and in view of the fact that many Sharia Supervisory Boards (SSB), which operate as religious advisory committees to ensure that their own banks’ activities are in compliance with the Sharia law, often propose substantial investments in poorer Islamic societies where credit risks are not particularly good, this of course also adds support to those who are not easily persuaded by arguments similar to those made by the Supreme Court of Pakistan.¹⁰⁶

Furthermore, another concern arises, namely the unfeasibility in the Islamic banking system to compensate inflation through interest.¹⁰⁷ Many Muslim countries face extreme levels of inflation¹⁰⁸ and this is severely affecting the real value of money, especially in the long run.¹⁰⁹ Because, even if the PLS system can control the inflation to a certain extent, there are always greater risks involved.¹¹⁰ Hence, Islamic banks cannot tackle the inflation problem

¹⁰⁴ Business Recorder, 30 Jun 2001, “Buy-back system, Murabaha Financing or Bai-e-Muajjal”, by Saalim Salam Ansari.

¹⁰⁵ The Sharia Appellate Bench of the Supreme Court of Pakistan, “The text of the Historic Judgement on Riba 23 December 1999”, p.130-131.

¹⁰⁶ Financial Times, Oct 26 2000, Survey – “Association sets new standards – Islamic banks have a long history of exposure to bad risks and the need for consistency is paramount”, by James Drummond; Financial Times, 13 Nov 2001, Survey: Site only – “Islamic banks are at the centre of a maelstrom despite little evidence that they have links to financing terrorism”, by James Drummond.

¹⁰⁷ Saeed, p.100.

¹⁰⁸ New Horizon, No. 112, September 2001, “Riba-free Commercial Banking”, by A.L.M Abdul Gafoor.

¹⁰⁹ New Horizon, No. 109, May/June 2001, “Riba, its Economic Rationale and Implications”, by Abdel Rahman Yousri Ahmad.

¹¹⁰ New Horizon, No. 109, May/June 2001, “Islamic banking: True Modes of Financing”, by Dr. Shahid Hasan Siddiqui.

with the same simplicity as can be done in the conventional banking system.¹¹¹ Due to worries about inflation and capital shortfall many Muslims choose to deposit their money in interest-based banks. In view of the fact that riba is not considered halal (permitted) this is however contrary to the Sharia. Still it is very common.¹¹²

¹¹¹ New Horizon, No. 112, September 2001, "Riba-free Commercial Banking", by A.L.M Abdul Gafoor.

¹¹² Interview with David Delfolie.

7 Financing facilities

Financing is perhaps the primary function of an Islamic bank. Between 50 and 80 percent of the total assets in Islamic banks are used for financing activities.¹¹³ Roughly, financing facilities can be categorised into three areas: investment, trade and lending. Different financing techniques are used to facilitate these areas, some are based on the PLS scheme, others on mark-up (commissioned purchase) and a few rely on benevolent loans.

Islamic banking principles are divided into two categories: (i) strongly Islamic and (ii) weakly Islamic. The former obeys both the objectives and the stipulated procedures of Islam, meanwhile the latter category only conforms to the form and procedures, but does not comply with the intention or the substance of the Islamic beliefs. When utilized according to the Islamic tradition, only two financing methods are regarded as strongly Islamic principles - mudaraba and musharaka, both partnership-financing methods.¹¹⁴ Therefore, it has been stated that the PLS principles are preferable. Still, commissioned purchase, using the mark-up method, is the most popular of them all, comprising more than seventy-five percent of Islamic banks' financing.¹¹⁵ Hardly any Islamic bank is channelling more than ten percent of its total financing activities through the two PLS methods, musharaka and mudaraba.¹¹⁶ A number of critics have referred this as a legal embarrassment.¹¹⁷ Later on it will be explained why.

The methods of financing are normally issued by the central banks. Thus, in Malaysia for instance, the central bank has issued guidelines of techniques to be used for Islamic financing activities. For illustration, the recommended practice of the ijara (leasing) is for the financing of vehicles and the preferable use of the mudaraba principle is for project financing and working capital. The musharaka principle however, is only recommended for project financing and quard hassan is only suitable for overdraft facilities and welfare loans.¹¹⁸

¹¹³ Haron & Shanmugam, p.111.

¹¹⁴ Ibid, p.81.

¹¹⁵ Saeed, p.95.

¹¹⁶ Haron & Shanmugam, p.127-128.

¹¹⁷ Vogel & Haves, p.293.

¹¹⁸ Haron & Shanmugam, p.113.

7.1 Investment financing (partnership financing)

7.1.1 Musharaka (equity participation contract)

This principle very much resembles the structure of a joint venture. Musharaka is a financing partnership, sometimes called equity participation contract, and is supported by several texts in the Sharia.¹¹⁹ However, no direct guidelines have been given as to the concept's validity in business situations. Still, jurists have justified the use of musharaka in business ventures, particularly through verses 4:12 and 38:24 of the Koran; a rather arbitrary justification some say.¹²⁰ The enterprise is an independent legal entity for which both the bank and the client provide capital. It is also normal that both parties participate in the management of the project. Profits are divided on a predetermined ratio, which does not necessarily need to reflect the capital contribution or management participation.¹²¹ Nevertheless, all *losses* are born in proportion to each partner's share in the financing of the venture.¹²² Many Muslim jurists consider this as "the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing in, and benefiting from, risk."¹²³ The partnership is usually of limited duration and the bank may withdraw after an initial period. It is common that Islamic banks offer an alternative to the time-limited partnership - *permanent musharaka* - sometimes also called *continued musharaka*. With this variant the bank will receive an annual share of the profits decided on a pre-ratio basis.¹²⁴ All the same, most musharakas are on a short-term basis.¹²⁵

As has been stated above, the profit ratio does not always reflect the capital contribution or management participation. Nonetheless, loss sharing is proportionate to the capital input. In some cases though it is difficult to estimate the value of the client's input and it might then be necessary to decide upon a pre-ratio also for potential losses. Such a musharaka deal could for instance be a joint venture in the oil and gas industry, where outside investors offer the capital and the oil- and gas company contributes with the rights to drill at specific locations. Profit and losses could then for example be shared on a 40-60 ratio, leaving the oil company with the larger part.¹²⁶ But as long as the value of financial inputs are clear, the parties must abide by the main rule, that is to say, loss sharing according to capital

¹¹⁹ Errico & Farahbaksh, IMF Working Paper (WP/98/30).

¹²⁰ Saeed, p.59 & p.74.

¹²¹ The various religious schools have different opinions on this matter. But the majority, represented by the Hanafi and Hanbali schools, claims there is considerable flexibility, see Saeed, p. 61.

¹²² Nida'ul Islam magazine (<http://www.islam.org.au>), "Principles of Islamic banking", published at <http://www.islam.org.au/articles/older/BANKING.HTM>

¹²³ Ibid.

¹²⁴ Haron & Shanmugam, p.127.

¹²⁵ Saeed, p.67.

¹²⁶ Vogel & Haves, p.195.

contribution. Some even claim that there is no flexibility at all and that a contract, which stipulates a loss ratio different from the proportion of capital contribution, is null and void.¹²⁷

7.1.2 Mudaraba

Also being a form of venture capital financing, the mudaraba principle fits those who lack funds but have the skills to conduct trade or business. This means that the bank is the investor and the client supplies the expertise and labour, an arrangement occasionally referred to as a trustee finance contract.¹²⁸

Mudaraba has evolved from an ancient form of financing principles practiced by the Meccan Arabs during trade caravans.¹²⁹ It was considered to be an efficient system for dividing fortunes and losses among the various partners. Today mudaraba is based on a different set of laws and has developed into a sophisticated concept, offered by all Islamic banks.

Similar to business projects financed through musharaka the profits in mudaraba ventures are divided in a pre-arranged proportion. An important difference is however that a potential loss, unless caused by negligence or an infringement of the contractual terms by the client, is entirely borne by the bank.¹³⁰ Thus, the investor will stand all financial risks and the entrepreneur loses the time and his efforts only. Therefore, even though the concept of mudaraba is often referred to as a profit and *loss sharing* model, that description is rather misleading and imprecise because, as has been pointed out above, there is no loss sharing in a mudaraba transaction. Instead, profit and loss sharing is a more accurate description of the musharaka institute where the profit and the losses in reality are shared. Since the concept does not require the creation of a separate legal entity a financier can make a mudaraba investment in any existing company, as long as its business is halal.¹³¹

It is essential to understand that both musharaka and mudaraba must rely on a proportional profit-sharing system and cannot be subject to lump sum agreements or deals stipulating guaranteed amounts.¹³² Agreements like that would merely be a substitute for interest, violating the Sharia law.

As to the management of the enterprise, the entrepreneur must be given all the necessary freedom. Any interference by the investor might affect the

¹²⁷ Saeed, p.62.

¹²⁸ Errico & Farahbaksh, IMF Working Paper (WP/98/30).

¹²⁹ New Horizon, No. 110, July 2001, "Mudaraba-based Investment and Finance", by A.L.M. Abdul Gafoor.

¹³⁰ IIBI, http://www.islamic-banking.com/shariah/sr_mudarabah.php.

¹³¹ Vogel & Haves, p.138.

¹³² Haron & Shanmugam, p.79.

efficiency. The entrepreneur “must have absolute freedom to trade in the money given to him and take whatever steps or decisions that he deems appropriate to realise the maximum gain. Any conditions restricting such liberty of action vitiate the validity of the act.”¹³³

An oddity with the *mudaraba* is that it is not a binding contract. There is a mutual understanding among scholars that the deal may be terminated at any time before the entrepreneur begins his work, simply by informing the other party of the decision.¹³⁴

Both the Shafi’is and the Hanafis argue that this is even permitted after the entrepreneur has begun his work, meanwhile the Malikis condemn such usage. Whether a fixed duration for a *mudaraba* contract can be specified is unclear. According to schools like Maliki and Shafi’i this is not possible and they say such term would render the contract void. Other schools, mainly Hanafi and Hanbali, consider such clauses permissible.¹³⁵

There is no direct reference to *mudaraba* in the Koran, but it has been argued that even the Prophet himself was involved in *mudaraba* ventures. Even so, there is no authentic Hadith to support this statement. The general view is that the principle has developed through commercial tradition, simply because there was a need for the contract.¹³⁶

Muqarada. A third technique, the principle of *muqarada*, also deserves some attention. In order to allow other investors to take part in an enterprise banks issue bonds to finance the particular project. The investors take a share in the profits, but also stand the risk to lose what they have put in. These investors do not have any voting rights nor may they participate in the management.¹³⁷

7.1.3 Economical consequences and business obstacles

About *mudaraba* it has been said:¹³⁸ “some people in the West have begun to find the idea attractive. It gives the provider of money a strong incentive to be sure he is doing something sensible with it. What a pity the West’s banks did not have that incentive in so many of their lending decisions in the 1970s and 1980s. It also emphasizes the sharing responsibility, by all the users of money.” This comment implies that the PLS system, including *musharaka*, requires careful evaluation of a project’s sustainability to assess whether it should be carried out at all. A few scholars may suggest that this is an efficient way to avoid financial bubbles, like those bursting in the late

¹³³ Saeed, P.54.

¹³⁴ Ibid, p.54.

¹³⁵ Ibid, p.54.

¹³⁶ Ibid, p.52.

¹³⁷ Nida’ul Islam magazine (<http://www.islam.org.au>), “Principles of Islamic banking”, published at <http://www.islam.org.au/articles/older/BANKING.HTM>

¹³⁸ Gafoor, p.72.

1980's/early 1990's, but the validity of these arguments is often disputed. For instance, some critics argue that the control- and supervising mechanism, which is required in PLS financing, might hamper innovations. Normally, banks will only enter into a partnership agreement if they believe it will be profitable. If banks and not the innovators themselves shall determine the potential market and decide whether the enterprise may be profitable or not, there is an apparent risk that the banks will be too cautious and that there will be no incentives left for new ideas.

Another problem is how to encourage financiers to actually choose the Islamic banking profit- and loss-sharing (PLS) scheme instead of traditional means of financing when they can borrow the amount needed for only a moderate rate of interest in a conventional bank. Tarke El Diwany, a writer on Islamic banking, exemplifies this dilemma by referring to an authentic discussion he had with the chairman of a major Asian construction company that specialised in building toll roads. El Diwany suggested the Chairman to seek finance for the company's following project via a toll revenue-sharing package, where the Islamic bank would part-finance the toll road and share the toll receipts with the firm. "This would be good for his company because if no one used the road, there would be no financing cost. With the interest based alternative, whether the toll road was full or empty, there would still be a financing cost. But the chairman felt that 7% interest was a good deal and so our suggestion was not adopted. Probably this was because he knew that the toll road was going to provide profits of 30%, and there's no point paying out 30% in profit share when you can pay out 7% in interest instead, is there? Well, the economy turned down, fewer motorists than predicted used the toll roads, but the interest still had to be paid. And so the company had to be rescued. The Financial Times commented a few days later that the rescue was required because 'interest costs exceeded toll revenues'. I kept that article because it summarised with a real life example everything that true profit-sharing would have avoided. The moral of the story is that the chairman wants to fix his financing cost because he believes his business is going to be profitable and he wants to keep most of the profit to himself. He's practising financial leverage like all those un-Islamic textbooks tell him to."¹³⁹

Accordingly, partnership financing does not appear to be a particularly attractive alternative for conventional investors as long as profitability is nearly certain because market outlooks are good. It is therefore likely that only when the venture involves greater uncertainty and the prognosis of the economy is not longer that impressive that the PLS-scheme will exist as an appealing alternative for traditional capitalists. Most certainly this concern is only one among many other reasons why Islamic banks show considerable reluctance in applying the model more extensively, accounting for merely ten per cent of the Islamic banks financing activities.¹⁴⁰

¹³⁹ El Diwany, "Islamic banking isn't Islamic", <http://www.islamic-finance.com>

¹⁴⁰ Haron & Shanmugam, p.127-128.

An interesting detail, especially when viewed in the light of the recent slump in the world economy, is that Islamic banks have managed remarkably well during the last two years, despite the September 11 attack in New York 2001.¹⁴¹ This does not correspond to what has been suggested in a report published by IMF in 1998, in which Luca Errico and Mitra Farahbaksh argued, that Islamic banks in practice have a low robustness to absorb external shocks. A possible reason for the unexpected resistance among Islamic banks might just be the restrictive appliance of the PLS-concept in combination with a limited exposure of risk when the banks really do engage in PLS ventures. Also, seventy-five per cent of Islamic banks financing is channelled through commissioned purchase (murabaha), where profit takings are realised more rapidly, limiting the threat of credit-losses.

7.1.4 Ethical issues

Furthermore, many ethical arguments have been raised when discussing the PLS scheme. Most of all, the concept relies on honesty. Critics argue that dishonest clients may be tempted to exploit the PLS techniques by not disclosing the real profits and consequently not paying the accurate return to the bank. In response to this the Sharia Appellate Bench of the Supreme Court of Pakistan claims that this problem is not hard to overcome, because "...if any misconduct, dishonesty or negligence is established against a client, he will be subjected to punitive steps, and may be deprived of availing any facility from any bank in the country, at least for a specific period."¹⁴² It is, however, debatable whether this would have prevented the involved parties from carrying out the massive fraud in 1998, where Dubai Islamic had to be rescued from bankruptcy.¹⁴³ A reader of Business Recorder, who criticised the Pakistani verdict, summarised this dilemma in a very clear-cut way, saying:¹⁴⁴ "What are the guarantees that the borrowers will not doctor their books to show losses on paper, for avoidance paying returns...One of the hallmarks of Islamic banking is trust. How can this be guaranteed in a country rated one of the most corrupt, and which has a history of robbery through bank loan defaults, misappropriations and other financial crimes?"

¹⁴¹ Business Times (Malaysia), 20 Feb 2002, "Islamic banking shows strong growth during tough times", by Nuryushida Laily Yusof; Gulf News, 18 Mar 2002, "Islamic finance sector growing at rapid pace", by C.L. Jose.

¹⁴² The Sharia Appellate Bench of the Supreme Court of Pakistan, "The text of the Historic Judgement on Riba 23 December 1999", p.133-134.

¹⁴³ Financial Times, Oct 26 2000, Survey – "Association sets new standards – Islamic banks have a long history of exposure to bad risks and the need for consistency is paramount", by James Drummond.

¹⁴⁴ Business Recorder, 18 Jan 2000, Letter: "Islamic banking".

7.1.5 Problems with non-binding contracts

One problem, which does not involve the principle of musharaka, is that the mudaraba contract is not binding until the entrepreneur has started his work. As has been stated above, some scholars suggest that the contract is not even binding after the actual work has commenced. This might put the entrepreneur in a difficult situation, especially if he is under time pressure. Seeking new investors for the project can be very time-consuming and a new financier will of course also want to assess the project. Moreover, the assessment itself is sometimes a rather slow procedure and it might delay the enterprise even further. There are also other problems associated with the non-binding mudaraba contract, but I will settle with pointing to the fact that the non-binding contract is a factual problem.

7.1.6 Supervision and control by the central bank

Besides the obstacles with the non-binding character of mudaraba, many central banks in conventional banking systems find it rather hard to carry out its duties as to supervision and control when Islamic banks are involved. Since Islamic banking laws encourage financing through PLS techniques where the bank often acts as the investor and partner, it is difficult to determine whether these banks fulfil the liquidity requirements and it is also hard to assess the adequacy of the capital.¹⁴⁵ In turn, both liquidity matters as well as sufficiency of capital depend on the value of assets, which as to Islamic banking normally is rather difficult to assess. In traditional banking it is much easier to determine the value of funds since the main part of the assets are usually fixed through interest instruments with a quoted market value. But to value a share in a joint venture is very difficult. Up till now, there is a general lack of uniformity in accounting standards accepted by the Islamic banking community. Attempts are being made by AAOIFI (Accounting and Auditing Association for Islamic Financial Institutions) to standardize accounting across the Islamic banking community, but to date only a few countries have adopted the suggested standards and there is still disagreement on a number of issues.¹⁴⁶ For example, the question as to when earnings for a commissioned purchase contract (murabaha) should be recognised is by many experts still considered as an unsolved matter.¹⁴⁷

Lately, other ideas to evaluate Islamic banks and its assets have been put forward. A so-called CAMEL-rating system (Capital, Assets, Management, Earnings and Liquidity) has been proposed. CAMEL-rating is a measure of

¹⁴⁵ Gafoor, p.62.

¹⁴⁶ Financial Times, Oct 26 2000, Survey – “Association sets new standards – Islamic banks have a long history of exposure to bad risks and the need for consistency is paramount”, by James Drummond.

¹⁴⁷ Financial Times, 13 Nov 2001, Survey: Site only – “Islamic regulator sets standards not all wish to follow. Islamic banks are creations of their own jurisdictions and there is little consistency – or co-operation between any two centres”, by James Drummond.

the relative soundness of a bank, which shall reflect a bank's financial condition, including capital adequacy and the bank's compliance with supervisory regulations.¹⁴⁸ At present, however, the rating system is only considered as an innovative suggestion.

So, in order to make an accurate valuation of an Islamic banking joint venture agreement it would clearly require a great deal of work by analysts. And even if correct and easy calculations for estimating the value would be possible, it would still not be easy to assess the profitability of the project, because the Sharia law stipulates that returns on such investments cannot be guaranteed and that is why the profitability is so challenging to evaluate.¹⁴⁹

Consequently, and because of the special characteristics of PLS ventures, as well as the absence of uniform accounting standards adopted by Muslim banks, it is obvious that there are substantial problems regarding the supervision of Islamic banks. It is, however, not to be expected that countries relying on conventional banking systems will accept a reduction as regards the monitoring of the banking sector. Gafoor, a writer on Islamic banking, says:¹⁵⁰ "any relaxation of strict supervision is precluded because should an Islamic bank fail it would undermine the confidence in the whole financial system..."

7.1.7 Summary

In essence, there are two methods that dominate the concept of investment financing, both operating on a scheme where profits and losses are divided between the investor, respectively the entrepreneur. As a partnership funding principle, the musharaka technique to a large extent resembles a joint venture agreement. The investor, normally the bank, as well as the entrepreneur himself, both provide capital for the business enterprise and more often than not, both parties take part in the management. While losses are born in proportion to each party's capital contribution in the project, profits do not need to reflect the participation in the management nor does it need to mirror the financial inputs. It has been said that the musharaka instrument is the purest form of Islamic banking and the practice is supported by several verses in the Koran.

Conversely, there is no direct reference to the mudaraba instrument in the Koran. Instead it has been recognised and justified as a commercial tradition. The investment financing method of mudaraba is a partnership, which is especially well suited for entrepreneurs that lack the necessary capital to finance a project. The bank, acting as the investor, offers financial assistance and the entrepreneur supplies the expertise and labour. Just like

¹⁴⁸ Errico & Farahbaksh, IMF Working Paper (WP/98/30).

¹⁴⁹ Gafoor, p.63.

¹⁵⁰ Ibid.

in financing through musharaka, profits are divided on a pre-determined basis, but in contrast to musharaka losses are completely born by the bank. A peculiarity with the mudaraba contract is that it is not considered as a binding agreement, and therefore brings much uncertainty to innovators.

Profit- and loss-sharing financing has been put forward as an ethical banking method and is said to endorse shared responsibility. Meanwhile, critics are unconvinced about the concept's superiority, as dishonest clients may be tempted to exploit the PLS techniques by not disclosing the real profits. Moreover, there are obvious problems associated with the central banks' duties when it comes to supervision and control. The reason for this is that certain liquidity requirements need to be satisfied, but that it is rather problematic to determine the value of funds in an Islamic bank, especially if a large proportion of the assets consist of shares in various business projects and joint ventures. Additionally, there are apparent difficulties in evaluating the profitability of such enterprises, since returns are not guaranteed.

7.2 Trade financing

This mode of financing includes leasing (ijara), sell-and-buy-back contracts and also the use of letters of credit. But most of all trade financing is accomplished through commissioned purchase by using the murabaha contract, which undoubtedly is the most widely used method in Islamic banking. In this chapter the latter will be assessed.

7.2.1 Murabaha (mark-up/commissioned purchase)

7.2.1.1 The model

The murabaha principle is a short-term investment mechanism often used for the purchase of machines and other goods. Even though technically being a form of business participation the bank is not considered as a partner and is therefore not allowed to interfere in the client's management.¹⁵¹ The financing technique is based on a mark-up, a form of commissioned purchase through a cost-plus-profit contract. In practice, this means that the bank buys the item from the seller and then resells it to the buyer, but for a higher price. Of course, the buyer does not have the money to make the purchase so he borrows the same amount from the bank. With this method the bank can make a nice profit through lending activity.¹⁵² The major difference from conventional banking is that it has been done by means of trade and not due to dealing in interest. The loan will be paid back to the bank over an agreed period of time, but it is important to note that the

¹⁵¹ Saeed, p.78.

¹⁵² Haron & Shanmugan, p.79.

agreement between the bank and the client is final, so the amount payable to the bank will never exceed the agreed price for the item.¹⁵³

7.2.1.2 Sources

Murabaha cannot be traced back to the Koran, neither to the Sunna. Jurists have justified the use of the principle on other grounds. The Malikis have acknowledged the method since they claim it has always been the practice of the people in Medina. The Shafi'is and the Hanafis justify the murabaha technique on other grounds, but it is evident that all three of them accept the usage, and as long as it is employed in its original meaning they consider it to be in conformity with the Sharia law.¹⁵⁴

7.2.2 Similarities with interest lending

From time to time the model of murabaha has been referred to as legal embarrassment. One reason for this is the use of time-value; another reason is that the bank does not stand any risk what so ever during the transaction, which is a clear deviation from the fundamentals of Islamic banking law. Furthermore, Islam requires the lender to give the debtor extra time if he fails to make an instalment, but also this essential rule is constantly being violated. These matters, among other things, will be assessed below.

7.2.2.1 Risk factor

Under conventional murabaha, the Islamic bank earns profits, which originate from real services that involve certain risks. In brief, the bank is not entitled to any returns or addition to the principal sum unless it shares in the risks involved. Therefore, the assumption of risk is of utmost importance.¹⁵⁵ The title to the goods will be transferred from the seller to the bank and then finally obtained by the client through the purchase. Hence, Islamic banks argue they stand a certain risk when they obtain the title and that it therefore is a legitimate financing method.¹⁵⁶ However, it is heavily debated whether there really *is* an apparent risk associated with the transaction that in the end can justify the use of murabaha. An interesting point is that with modern technique the title to the specific item may be possessed by the bank for merely one tenth of a second, making the transaction permissible in theory, but by many Muslim jurists regarded as a prohibited deviation from the basics of Islam. The difference between the

¹⁵³ Rahman, Dr. Yahia Abdul, p.97.

¹⁵⁴ Saeed, p.77.

¹⁵⁵ Business Recorder, 22 July 2001, "A critical evaluation of Murabaha Moajjala", by Anwar Ahmed Meenai.

¹⁵⁶ Nida'ul Islam magazine (<http://www.islam.org.au>), "Principles of Islamic banking", published at <http://www.islam.org.au/articles/older/BANKING.HTM>

additional cost imposed on the client in a murabaha contract and the payable costs for the benefit of a conventional banking loan is that the former is not interest on loan, which the Koran forbids, “but your thanks to the bank for the risk it takes of losing money while it is the owner of the machinery: this is honest trading, okay with the Koran. *Since with modern communications the bank’s ownership may last about half a second, its risk is not great, but the transaction is pure. It is not surprising that some Muslims uneasily sniff logic-chopping here* [own italics].”¹⁵⁷

Subsequently, critics argue that a number of Islamic banks have made extensive modifications to the financing practices of murabaha (commissioned purchase) and that in many cases the very purpose of interest-free financing has been defeated. For instance, instead of actually buying the property, taking the possession of it and selling it back to the client, the transaction has sometimes been reduced to mere paper work. Traditionally, murabaha is a form of business participation and the Sharia requires that the financier actually buys the goods before he sells them back to the client and for this reason some critics claim that the murabaha contract is only a disguise for interest lending, simply being a change of name and therefore raising questions about morality.¹⁵⁸ It is a fictitious deal they say, where the bank, without actually dealing in the goods, is ensured a prearranged profit and this without sharing any actual risk. Dr Hasanuz Zaman concludes that the Islamic banks “...have failed to do away with undesirable aspects of interest. Thus, they have retained what an Islamic bank should eliminate.”¹⁵⁹

Also, the Federal Sharia Court in Pakistan has concluded this to be inconsistent with Islam, because such use of the principle does not appear to be much different from conventional interest lending.¹⁶⁰ Dr Hasanuz Zaman once stated:¹⁶¹ “...the banks are compelled to play tricks with the letter of the law. They actually do not buy, do not possess, do not actually sell and deliver the goods; but the transition is assumed to have taken place. By signing a number of documents of purchase, sale and transfer they might fulfil a legal requirement but it is by violating the spirit of prohibition.”

It is not only the risk during the possession of the goods that is eliminated, but also the responsibility as to errors in the merchandise. The reason for this is that the bank usually appoints its clients as agents to purchase and obtain the goods, placing the responsibility on the client to examine the merchandise and making them responsible for any such defects.¹⁶²

¹⁵⁷ Gafoor, p.57.

¹⁵⁸ Ibid, p.58.

¹⁵⁹ Ibid, p.60.

¹⁶⁰ Ibid, p.58.

¹⁶¹ Ibid, p.59.

¹⁶² Vogel & Haves, p.141.

A complementary way for the bank to avoid these risks is by means of insurance, but this will of course be born by the client, as it is a cost added to the murabaha expenses.¹⁶³

7.2.2.2 Time-value

Another issue is that the mark-up tends to differ according to the length of the loan period. If deferred payments will be made during a longer period of time, then normally, the profit made by the bank will also be higher. The Tadamon Islamic Bank's Supervisory Board claims this is permissible, because it is not a conventional loan, but a financial transaction. This also appears to be the mainstream view among Islamic banks.¹⁶⁴ In an attempt to justify the practice, jurists that are supporting the use of time-value, have stated that in conventional banking a loan will be obtained at a given interest rate for buying goods *without* the certainty of knowing how much the actual cost will be. With murabaha the client will know *beforehand* the total cost of the goods.¹⁶⁵ Nevertheless, due to the similarities with conventional banking loans with fixed interest rates it is obvious that many people will consider the approval of time-value in money transactions as an acceptance of interest. As a result, many experts on Islamic banking have strongly condemned the use of time-value as inconsistent and illogical.¹⁶⁶

Moreover, many of the aspects affecting interest rates in conventional banking systems also influence the mark-up in murabaha, giving rise to similar levels of return. In reality it is possible that the mark-up will be even higher than the usual interest because the financing method involves more costs than interest-based transactions. Costly preparations for the contract and the transaction are required and greater amounts of paperwork also add to the total cost of the commissioned purchase (murabaha). The Chief Executive of the Qatar Islamic Bank has confirmed the relation between mark-up and interest rates, saying: "Rates of interest are taken into account when the mark-up on murabaha transactions is determined. This is being practical and facing the facts of life. Inflation is measured, and rates of interest and inflation are compared to each other."¹⁶⁷

7.2.2.3 Delays in payment

Judging by what has been concluded above, it could be said that murabaha is not much different from fixed-interest-financing. A significant difference, in theory, is however that if a debtor in an interest-based loan agreement fails to make an instalment at a specified time, an interest penalty will

¹⁶³ Saeed, p.85.

¹⁶⁴ Ibid, p.82.

¹⁶⁵ Ibid, p.83.

¹⁶⁶ Ibid, p.95.

¹⁶⁷ Ibid, p.84.

normally be imposed, whereas Islam requires the lender to give the debtor extra time without enforcing any penalty fee. The Institute of Islamic Banking and Insurance supports this view¹⁶⁸, but more importantly the Koran upholds the idea. In the Koran, verse 2:280, it says: "...if the debtor is in difficulty, give him respite till ease." Referring to this distinguishing feature, this has also been heavily criticised by conventional bankers when discussing Islamic banking.

Even if penalty enforcement is contrary to Islamic beliefs most Islamic banks *do* seek compensation through such means.¹⁶⁹ But regardless whether it is called fee or interest, it is basically the same thing. The Faisal Islamic Bank of Egypt tries to defend its use of penalty fees by referring to a Sharia rule stating that no mischief shall be inflicted to any party of the contract. On the basis of this rule the bank employs the following text in its murabaha contracts: "Since the bank does not deal with interest, any delay in paying the instalments ...causes serious harm to the bank, which requires compensation...the bank has a right, without any objection or dispute [by the client], to demand compensation for any damages occurred because of the delay."¹⁷⁰ The Banque Misr uses an even more controversial contract saying that any delay "deserves an initial and immediate compensation at the rate of xx *percentage* [own italics] without any warning, excuse or legal judgement."¹⁷¹ Two Sharia rules appear to be violated here. First of all, no respite is given to debtors who are in difficulty and secondly, there is an infringement of the *riba* prohibition.

Grindlays bank in Pakistan imposes the controversial penalty fee through a sell-and-buy-back contract, where the bank will buy from the client goods for e.g. \$100 and sell it back to him for \$120.¹⁷² With this method no interest has been charged, but the bank has still received compensation for the delay in repayment. Clearly, the economical consequences of such sell-and-buy-back transactions are no different from those deriving from interest-based methods. Still, many Muslim jurists support the use of this mechanism, especially the ones who are concerned about economical growth and development.¹⁷³

7.2.2.4 A legal embarrassment

The murabaha principle comprises more than seventy-five percent of Islamic banks' financing activities. Islam encourages PLS-based solutions, but these only account for ten percent of the transactions, and as has been concluded in a report published by IMF, the PLS principle is hardly ever

¹⁶⁸ IIBI, http://www.islamic-banking.com/shariah/sr_bf.php

¹⁶⁹ Saeed, p.89-90.

¹⁷⁰ Ibid, p.91.

¹⁷¹ Ibid.

¹⁷² Ibid.

¹⁷³ Bogdan, p.228.

strictly applied.¹⁷⁴ Since Islamic banks' appear to survive primarily on non-PLS financing techniques this has been referred to as a legal embarrassment.¹⁷⁵ Even for the Islamic Development Bank that has as its primary task to give financial assistance for development purposes to its members, seventy-three percent of its total financing is carried out through murabaha.¹⁷⁶ In response to this profound reliance upon murabaha (commissioned purchase/mark-up), the Deputy Prime Minister of Malaysia, Datuk Seri Abdullah Ahmad Badawi, in a fairly recent interview, revealed that he wishes to see a noticeable shift from the more commonly utilised mark-up method towards an increased employment of PLS-based transactions.¹⁷⁷

That so many banks and clients prefer the murabaha method of financing is, however, not particularly surprising. Because, as has been concluded in a report published by the United Nations Development Programme (UNDP), the bank stands larger risks and must often cope with excessive evaluation costs when utilising the PLS-financing methods (see chapter 8.5 below). At the same time, since the amount owed to the bank in a profit sharing contract often exceeds the amount to be paid in a murabaha contract, the borrowers also face potentially higher borrowing costs in PLS-mode financing, when the project succeeds. Accordingly, banks and borrowers often choose the mark-up model.¹⁷⁸

Another concern is that Islamic banks have significantly twisted the principle of murabaha. They have on dubious grounds justified Sharia-contrary behaviour, e.g. the allowance of time-value and the enforcement of penalty fees on clients who are unable to pay. Many scholars now demand that the banks reduce their use of synthetic murabaha transactions, that is, contracts that very much resemble interest lending. Others insist that the concept shall not be employed at all, because they consider both the concept itself, as well as the widespread practice of complicated contractual texts in murabaha transactions, to be a shameful fact of Islamic banking.¹⁷⁹ The application, they say, is no more than a dishonest method to avoid the riba proscription.

A related issue is the sell-and-buy-back contract (see above, chapter 7.2.2.3), which is a variation on the commissioned purchase model - murabaha. While a number of classical schools of law consider this transaction to be a device merely designed to circumvent the prohibition of riba, other schools, for instance the Shafi school, considers it as a valid

¹⁷⁴ Haron & Shanmugam, p.127-128; Errico & Farahbaksh, IMF Working Paper (WP/98/30).

¹⁷⁵ Vogel & Haves, p.293.

¹⁷⁶ Saeed, p.78.

¹⁷⁷ New Strait Times (Malaysia), 27 Oct 2001, "DPM: True strength of this system not exploited".

¹⁷⁸ Dhumale & Sapcanin, UNDP, "An application of Islamic Banking Principles to Microfinance".

¹⁷⁹ El Diwany, "Islamic banking isn't Islamic", <http://www.islamic-finance.com>

contract of sale, notwithstanding the intention of the parties, which by the Shafi'is is viewed as irrelevant.¹⁸⁰ Malaysia has opted for the Shafi school and therefore consent to the appliance of the sell-and-buy-back contract, meanwhile the Sharia Appellate Bench of the Supreme Court of Pakistan, condemns the usage, saying it is to "...make fun of the original concept" and claiming it to be "...repugnant to the Holy Qur'an and Sunnah."¹⁸¹

Referring back to the previously discussed ambiguity, relating to the legality in the appliance of the murabaha model, Siddiqi, a writer on Islamic banking, has stated: "I would prefer that bay'mu'ajjal [murabaha] is removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form, we have the overriding legal maxim that *anything leading to something prohibited stands prohibited* [own italics]."¹⁸² Abdullah Saeed has chosen a different approach, saying: "If Islamic law can allow murabaha financing as it is practised under Islamic banking then the question is, 'Is there any moral basis for not allowing fixed interest on loans and advances?'"¹⁸³

7.2.3 Innovative suggestions

Being referred to as a legal embarrassment, proposals for a more acceptable use of murabaha have been made, but mainly for supplementary purposes. The aim has been to divert from any abuse of the principle, to employ the practice in a Sharia recognized context and to allow the model to exist for a rightful purpose. In an attempt to present a financing contract based on these objectives Vogel & Haves have presented the 'Ownership-in-Transit' proposal. For instance, the model may become useful when neither the buyer nor the seller wants to tie-up its capital during the actual transfer of the goods. The bank could then act as an intermediary to sustain high liquidity for both parties. The following example illustrates the idea:¹⁸⁴ "Volvo is shipping new cars to its dealers in the Gulf. The dealers will not pay for these cars until they are landed in the Gulf, requiring Volvo to finance the cars during the several-week transit period from Stockholm to Jedda or Manama. Bahrain Islamic Bank (BIB), under the auspices of a much larger *murabaha* program, is identified to purchase the cars from Volvo as they are being loaded onto ships in Stockholm. BIB continues to own the cars for the period of transit, incurring all shipping and other costs and risks coincident with ownership. The price at which BIB purchases the cars from Volvo is set at a level which will allow the Islamic bank to earn a

¹⁸⁰ Business Times (Malaysia), 29 Oct 2001, "Malaysia expected to be darling of West Asians", by Nor Sadnawaty Saifuddin.

¹⁸¹ The Sharia Appellate Bench of the Supreme Court of Pakistan, "The text of the Historic Judgement on Riba 23 December 1999", p.113.

¹⁸² Saeed, p.95.

¹⁸³ Ibid.

¹⁸⁴ Vogel & Haves, p.240.

satisfactory profit, net all expenses, for the tie-up of its capital until the dealers remit payment for the cars.”

7.2.4 Summary

As a form of commissioned purchase, murabaha differs from the mudaraba and musharaka since the two latter are based on the PLS method, meanwhile the former refers to financing through a mark-up method. Even though there is no explicit support for the appliance in the Sharia the principle is widely accepted among Muslim scholars.¹⁸⁵ Some commentators argue that commissioned purchase is not much different from conventional interest lending because the trade element of murabaha, in its original meaning, does not longer exist. Instead, the practice has been reduced to mere paperwork where the bank does not really take possession of the traded goods albeit this is a legal requirement.¹⁸⁶ A related issue is that the bank may only seek compensation for its services if there is an evident risk associated with the transaction. Normally the merchandise is in the bank’s possession only for half a second and it is well questionable whether this is sufficient to support the utilization of the principle. Even the risk related to defects in the goods has been passed on to the clients, making them liable for any such shortcomings.

Moreover, the use of time-value in dealings has been debated, much because of its resemblance with interest-based lending. Supporters of the appliance claim that since the client will know the total cost of the murabaha contract beforehand it is a permissible financial transaction that awards the client greater certainty.¹⁸⁷

Also, although the Koran states:¹⁸⁸ ”...if the debtor is in difficulty, give him respite till ease” and even though penalty enforcement due to delays in payment is contradictory to Islamic law, Islamic banks time and again impose penalty fees on its clients. Referring to another Sharia rule lenders reason that no harm shall be inflicted to any party and that compensation therefore is defensible.¹⁸⁹

Conclusively, all these matters contribute to what has been alleged to be a legal embarrassment. In Islam it is mainly PLS solutions that are promoted as preferable means of financing, but all the same around seventy-five percent of most Islamic banks’ financing activities are channelled via commissioned purchase.¹⁹⁰ Combined with the debatable interpretation of the murabaha principle, this adds to the embarrassment.

¹⁸⁵ Saeed, p.77.

¹⁸⁶ Gafoor, p.58.

¹⁸⁷ Saeed, p.83.

¹⁸⁸ The Koran, verse 2:280.

¹⁸⁹ Saeed, p.91.

¹⁹⁰ Vogel & Haves, p.293.

7.3 Istisna (commissioned manufacture)

Also called istisna, this contract is a financing method used for the production of specific goods. It is also a frequently applied model for construction financing.¹⁹¹ In essence, istisna is an agreement where one party pays for goods to be manufactured or pays for something to be constructed. As a rule the ultimate user will make periodic instalments according to the actual progress in the construction or manufacture, e.g. a ferry company wants to buy a new ship and makes periodic instalment payments to the shipbuilder as the assembly moves forward. In theory the contract could be made directly between the end user and the manufacturer, but typically it is a three-party contract, where the bank acts as a conciliator. Using a structure called 'back-to-back' istisna that consists of two istisna contracts, this constitutes the basis of such an arrangement. Under the first agreement the bank agrees to let the client pay back on a longer-term schedule, whereas under the second contract the bank, in the function of purchaser, makes progress instalments to the producer over a shorter period of time.¹⁹² Normally, the bank achieves profits by imposing a mark-up, hence the bank's compensation is the differential between the value of payments under the two contracts. Clearly, there is a considerable resemblance with commissioned purchase through murabaha.

Similar to murabaha, no support for the principle of istisna can be found by studying the major sources of Islam. In fact, the majority of religious schools argue that the appliance is inconsistent with Sharia law. Only the Hanafi school accepts the istisna contract and merely, because there is a need for the customary practice.¹⁹³ Notwithstanding the lack of support for istisna, it is still a widely employed method among Islamic banks.

As regards the legal effect of the agreement, the majority of supporters say that the istisna contract is not binding for any party until the construction is ready and approved by the buyer or until the goods are made and accepted by the final purchaser.¹⁹⁴

7.4 Lending

Financing through lending is dominated by the principle of quard hassan, which can be defined as a benevolent loan. Since this principle does not generate any monetary rewards, it is understandably not a commonly practised mechanism among Islamic banks.¹⁹⁵

¹⁹¹ Ibid, p.147.

¹⁹² Ibid.

¹⁹³ Ibid, p.121.

¹⁹⁴ Ibid, p.146-147.

¹⁹⁵ Haron & Shanmugam, p.132.

Quard hassan. As stated above, quard hassan is seldom utilised as a financing model. In fact, several Islamic banks only employ the concept for loans intended for extraordinary reasons. Bank Islam Malaysia for instance, defines quard hassan as “an interest-free loan given mainly for welfare purposes. The borrower is only required to pay back the amount borrowed.”¹⁹⁶ An interesting trait with the quard hassan loan is that no return is guaranteed to lender, but *encouraged*. Basically, it is left to the borrower’s own discretion to reward the lender as a token of appreciation.¹⁹⁷ However, even though it is a benevolent loan, or ‘good loan’, the Islamic bank may charge the debtor for e.g. administrative costs by levying a service charge.¹⁹⁸ The lender may claim repayment at any time, but the borrower is also allowed to terminate the contract whenever he so wishes. The repayment must be made in the exact quantity lent, regardless of any changes in the market value.¹⁹⁹

7.5 Government transactions

As a final point, transactions between governments and Islamic banks have yet to be fully Islamised. Muslim jurists have still not developed efficient and suitable financing methods to be used in government transactions and as a result many governments must rely on interest-based functions. For example, transactions between the Iranian government and the banks in Iran are still conducted on a basis of interest.²⁰⁰ For some reason this is not viewed as interest in Iran, allowing the government to borrow on fixed rates of interest.²⁰¹ Problems concerning government borrowing will be discussed in chapter 8.4 below.

¹⁹⁶ BIMB, http://www.bankislam.com.my/pstpnegan_maksud_e.htm

¹⁹⁷ Bank Negara Malaysia, Economics department, “Money and Banking in Malaysia”, p.201.

¹⁹⁸ Errico & Farahbaksh, IMF Working Paper (WP/98/30).

¹⁹⁹ Vogel & Haves, p.106.

²⁰⁰ Haron & Shanmugam, p.119.

²⁰¹ Gafoor, p.50.

8 Financing obstacles

Because of the *riba* prohibition pure lending activities do not normally bring the bank any income. For that reason benevolent loans like *quard hassan* are not very popular as financing methods among Islamic banks. Instead, they are left with investment financing principles like *mudaraba* and *musharaka*, but most of all they prefer the mark-up method of *murabaha*. All three of them, the two former being principles based on the PLS scheme, and the latter being a trade financing method, are important financing principles that in its original meaning fully meet the requirements set out in the Sharia law. This chapter will not deal with questions whether the Sharia-based banking laws have been circumvented or not, this has already been discussed in previous chapters. The focus will instead be on the complications and adverse impact that the appliance of these principles may have on the relationship between the bank and the presumptive client. The major problems in Islamic banking primarily involve the PLS system, but there are also concerns as regards trade-financing channelled through mark-up methods.

8.1 Long-term projects

Even though entrepreneurship and continuing partnership are encouraged in Islam, Islamic banks appear to be either unable or unwilling to participate in long-term projects. Only around 10 % of the Islamic banks' total assets are invested into medium- and long-term projects and more than 65 % goes into short-term enterprises.²⁰² There are several reasons for this unsatisfactory situation. For every PLS project there is the requirement of comprehensive analysis to assess the potential of the enterprise. Normally, in a short-term project this is only needed on an initial stage, but in a long-term partnership the bank needs to be an active participant. The necessity of coinstantaneous supervision, as well as time-consuming negotiations and assessments, is a major reason for the reluctance among Islamic banks to engage in long-standing ventures.²⁰³ The costs are simply too high.

Long-term projects also tend to tie up capital for very long periods since profits cannot be accomplished prior to the closing stage of the project. In conventional banking, and contrary to PLS financed projects, monthly instalments are usually made on a regular basis. As this is not the case with Islamic banks, the latter cannot reinvest its funds as quickly as an interest-based bank could. Moreover, the level of risk is enhanced as the Islamic bank must await the outcome of the venture before it can re-obtain any of its inputs and receive any possible returns.

²⁰² Ibid, p.46-47.

²⁰³ Gafoor, p.47.

While profits cannot be accomplished prior to the closing stage of the project, long-standing ventures will drastically delay the payment of returns to depositors, who have entrusted the Islamic banks with their funds on a profit and loss sharing basis.²⁰⁴ Consequently, by facing the risk of losing clients due to deferral payment of returns and because of liquidity concerns and increased levels of risk, the Islamic banks do not prioritise long-term investments.

8.2 Small businesses

Many small-scale enterprises, especially undertakings in the service and construction sectors, have experienced difficulties in obtaining necessary financing under the PLS scheme.²⁰⁵ One reason for the unwillingness among Islamic banks to finance small-scale businesses might be the time-effort and the disproportionate costs that the assessment of the venture requires. Typically, small business projects do not generate sufficient returns to cover the cost of appraisal. This problem may also arise under trade financing, such as murabaha, when small undertakings seek assistance for small-scale purchases. In contrast to this, and as has been stated in chapter 5.1 above, the institute of Islamic banking and insurance argues that the PLS scheme in fact encourages small business enterprising. They claim that it is instead the interest-based system that discourages small businesses creativity, as these, unlike large businesses, do not have the necessary funds for further development.²⁰⁶ However, necessary funding for small enterprises would, they argue, be achievable by applying a PLS financing scheme. Referring to the obstacles just mentioned above, regarding the reluctance among Islamic banks in applying PLS methods to small-scale businesses, opinions similar to that of the institute do however seem to be nothing more than unrealistic convictions that may appear plausible in theory, but that are difficult to achieve in practice. In fact, a number of Islamic banks explicitly state that they only wish to finance medium size and major projects. One example is Faysal Bank of Pakistan.²⁰⁷

8.3 Running businesses

Businesses already in operation sometimes need fast and easy access to short-term capital and ready money for various purchases that need to be done without delay, as well as for assorted expenditures. In many situations the necessity of instant short-term financing is a call for approval of

²⁰⁴ Ibid, p.47-48.

²⁰⁵ Ibid, p.48.

²⁰⁶ IIBI, http://www.islamic-banking.com/shariah/sr_bf.php

²⁰⁷ Business Recorder, 03 Nov 2001, "Faysal Bank has introduced real Islamic banking in Pakistan".

emergency loans. Banks are usually disinclined to join in a partnership on a short-time notice, because there is not adequate time to evaluate the prospective of the venture. And as regards expenditures, these will not normally bring about any returns for the bank. The PLS scheme is simply not appropriate for these kind of ready-money transactions and the difficulty in sustaining this important group of businesses, which in many cases can be said to be the core section of a country's economy, is a factual dilemma.²⁰⁸ Trade financing through the principle of murabaha could be an alternative when capital is required for assorted purchases, but the requirement of fast and easy access to short-term capital is not particularly well suited for the appliance of murabaha. Also, expenditures cannot be funded through murabaha.

The following statement, made by a representative at the Bank of Industry and Mines of Iran, may serve as an example to highlight the obstacles associated with immediate short term financing when utilised under Islamic law.²⁰⁹ "Often the clients need to have quick access to fresh funds for the immediate needs to prevent possible delays in the project's implementation schedule. According to the set regulations, it is not possible to bridge-finance such requirements and any grant of financial assistance must be made on the basis of the project's appraisal to determine type and terms and conditions of the scheme of financing."

8.4 Government borrowing

The main obstacle related to government borrowing is that government loans are not always intended for investment purposes. Funds may for instance be required for pure expenditures. A second difficulty is that, even if loans would be granted for investment purposes this would not necessarily mean that the money would be invested in a dynamic and productive venture.²¹⁰ Whether the loan is approved for expenditure reasons or granted for unproductive business projects is irrelevant, because in both circumstances the bank will be left with no returns at all. Hence, no Islamic bank would support any of these transactions, as they would be devoid of profit.

In cases where funds really are devoted for productive ventures and enterprises, these are usually of the longer-term sort. Subsequently, and according to what has been explained previously, neither this is a particularly appealing alternative from an Islamic bank's perspective. As a consequence, seeing that the banks do not wish to finance pure expenditures, nor non-profitable investments, no viable alternatives for

²⁰⁸ Gafoor, p.49.

²⁰⁹ Ibid.

²¹⁰ Ibid, p.50.

governments who wish to seek Sharia-conform funding, can be said to exist.²¹¹

Aware of the difficulties associated with government borrowing using PLS-methods, most Islamic governments still rely on interest-based borrowing.²¹² Many of them claim that this shall not be looked upon as interest-based lending. In Iran “it has been decreed that financial transactions between and among the elements of the public sector, including Bank Markazi [the central bank] and commercial banks that are wholly nationalised, can take place on the basis of a fixed rate of return; such a fixed rate is not viewed as interest. Therefore the Government can borrow from the nationalised banking system without violating the Law.”²¹³ Naturally, this is a controversial standpoint, but many modern scholars regard it as a necessary departure from the Sharia law. Nevertheless, although not yet devoid of interest-based transactions, the Pakistani government has promised to eventually abolish all interest-paid banking activities to ensure that the economy is completely in line with Islamic practices. This has however proven itself to be a very complicated task and the date of implementation has been rescheduled several times.²¹⁴

Suitable financing methods for government borrowing do not yet exist in Islamic banking, but a few suggestions, presented by various scholars, have been discussed. An interesting proposal is Siddiqi’s idea that loans to the government shall be interest-free and provided by the public, if necessary supported by tax breaks and mandated by law.²¹⁵

Chapra, another scholar, has perhaps come up with the most interesting thought, which is financing through an *istisna* contract.²¹⁶ His idea is that the government or public authority specifies what type of investment it wishes to carry out (object, amount etc.) and how many years the public body needs to make the repayment. Then, contractors are invited to submit their bids. Once a contractor has been selected it will construct the required facility and sell it to the public authority for a price paid in instalments. Gradually, the ownership will be transferred to the public body with a profit margin being added to the actual cost of the construction.

How the *istisna* financing method in practice could be utilized in a government transaction has been well exemplified in the following illustration, provided by Vogel & Haves:²¹⁷ “The Government of Malaysia is building a twenty-mile highway and awards the contract to the Regional

²¹¹ Iqbal, p.44 .

²¹² Haron & Shanmugam, p.119 – both Iran and Pakistan still maintain interest-based transactions.

²¹³ Gafoor, p.50.

²¹⁴ New Horizon, No. 110, July 2001, “Pakistan - Supreme Court Suspends Implementation of Islamic Banking for One Year”.

²¹⁵ Haron & Shanmugam, p.119.

²¹⁶ Ibid.

²¹⁷ Vogel & Haves, p.283.

Construction Company (RCC). RCC goes to the Islamic Bank of Malaysia (IBM) and negotiates an *istisna'* contract for the construction of the highway in one-mile increments. IBM advances the funds for each individual mile at the time of actual construction. When RCC delivers to IBM the completed one-mile segment, IBM in turn sells the segment to the Malaysian Government in a cash or credit (deferred payment) sale.”

With this model funding of unproductive ventures would be achievable, but still no solution has been provided for loans that are needed for pure expenditures.

8.5 Other related problems

In theory *mudaraba* and *musharaka* have been alleged to form the basis of Islamic banking. But in practice only ten percent of the transactions are carried out as PLS investments.²¹⁸ There are several reasons for this.²¹⁹ For instance, several Islamic banks argue that the utilisation of the PLS scheme is simply too costly and very inefficient, mostly because of the requirement of careful project assessment and the constant need for monitoring the progress of the venture. Consequently, Islamic banks will only employ the PLS financing methods in low-risk projects of short-term nature, where profits are almost certain and where the client is an effective manager with sufficient experience in business enterprising.²²⁰

Moreover, some scholars claim that there is a considerable reluctance among the entrepreneurs themselves. Even though management interference is not that evident in *mudaraba* financing as it is under the principle of *musharaka*, supervision and monitoring rights in a PLS financing system involve more direct intrusion by the bank than a traditional financing system does. As a result, the entrepreneurs' sovereignty and freedom of manoeuvre are somewhat circumvented and this in turn might be a discouraging element. Shahrukh R. Khan, a writer and researcher on Islamic banking, agrees to this, saying:²²¹ “The heavy supervising and monitoring rights allowed to the banks and the fear of disclosure that companies have may in any case restrict the use of this investment mode of finance from the entrepreneurial point of view.”

Another concern is the ability for the entrepreneur to pass the risk on to the bank. This is above all a peril in *mudaraba*-financed ventures where the entrepreneurs often participate without providing any personal funds. Two possible consequences can be recognized. Firstly, there is an apparent risk that the project gradually develops into an enterprise with a higher risk

²¹⁸ Haron & Shanmugam, p.127-128

²¹⁹ Saeed, p.71-73.

²²⁰ Saeed, p.71-73.

²²¹ Ibid, p.71-72.

profile than first was intended. Secondly, financing through PLS transactions may hold back incentives to reduce costs and may well raise questions on, for instance, efficiency concerns.²²²

Furthermore, Islamic banks usually do not have the necessary professional staff for the assessment and operation of PLS enterprises, so the evaluation of a project will most likely require employment of engineering and management experts.²²³ These costs will almost certainly be passed onto the client, normally making it a more expensive option than financing by conventional banking methods.

Also, critics refer to the apparent difficulty for investors to plan for the future.²²⁴ They point to the fact that it is quite challenging for the financier to plan for the future when one does not know what will happen to one's investments until the end of the financial year or before the PLS project has been concluded. From a financier's point of view this is a significant weakness in comparison with more certain, interest-based lending activities.

As a final point, it must be disclosed that there is much scepticism regarding the Islamic banks' ability to cover losses in non-profitable PLS projects without asking for an enormous and disproportionate share of the profit in those PLS partnerships that actually do generate returns.²²⁵ A development in that direction is not unlikely, especially since this would not be contradictory to the Sharia law.²²⁶

8.6 Summary

Unmistakably, financing is a complex area in Islamic banking law and several problems arise when clients seek Sharia-conform funding. Islamic banks are not keen on supporting long-term projects, because of the extensive requirements for thorough analysis and due to the need for constant monitoring of the venture. For various reasons the banks are also reluctant to tie up capital for longer periods.

Seeking financing for small enterprising can also be a hassle. Financiers are often sceptical about small-scale ventures by reason of the discrepancy flanked by the imposed costs and the level of profits. At the same time running businesses will sometimes have difficulties in acquiring fast and easy access to short-term capital, especially when needed for pure expenditure reasons.

²²² Ibid, p.73.

²²³ Saeed, p.72; Iqbal, p.44 .

²²⁴ Rahman, Dr. Yahia Abdul, p.24.

²²⁵ Ibid, p.25.

²²⁶ Saeed, p.61.

Furthermore, governments may experience problems in obtaining funds for non-profitable investments, where the appliance of the PLS scheme will not generate any returns for the bank. Commissioned manufacture, that is financing through an istisna contract, has been suggested as a suitable financing solution for government investments. But this would still not be the answer to essentials such as money supply for downright expenditures.

Moreover, PLS financing in general has been claimed to be too costly, time demanding and uncertain. Constituting a major part of the costs, the necessity to employ experts to evaluate the projects is one obstacle. Some scholars also fear that the banks' involvement may obstruct the management and subsequently discourage entrepreneurship. Additionally, it has been suggested that the PLS-scheme does not provide the right incitement for entrepreneurs to enhance cost-efficiency, because the financial risk is mainly passed on to the financier, not the entrepreneur.

Finally there are worries that the Islamic banks occasionally will be forced to ask for a lion's-share of the earnings in profit-generating enterprises to cover up for losses made in ventures that have not been that successful.

9 The Sharia Supervisory Board

To ensure that their banking activities are in conformity with the Sharia law, religious supervisory boards are widely used by Islamic banks. Also called the Sharia Supervisory Committee or Sharia Supervisory Board (SSB), the SSB examines contracts, dealings and transactions to assure that Islamic beliefs are not dishonoured.²²⁷ The committee can therefore be said to exist as a guarantee against abuse to certify that the banking activities are halal (permissible). The SSB is merely an advisory body, but nevertheless it has an authoritative and respected function as the bank entrusts the SSB with questions as to the permissibility of its activities.

An SSB is not inevitably regarded as a necessity in all countries. In Iran and Pakistan for instance, the setting up of such a committee is considered as pointless, mostly because these states instead have public bodies to supervise and give rulings on banking operations.²²⁸ In Malaysia however, the central bank does not recommend any granting of licenses for Islamic banks unless they fulfil the requirement to include a provision for the formation of a Sharia advisory body in their articles of association (Section 3, paragraph 5b of the Islamic Banking Act, 1983).²²⁹ Consequently, the SSB must be deemed as a decisive authority in Malaysian Islamic banking. Worth mentioning is also that both the Dow Jones' Islamic stock exchange index, as well as the UK-based FTSE International's Islamic index, make use of SSB:s to decide on Sharia-permissible stocks.²³⁰

9.1 Its function and responsibilities

The three central responsibilities of an SSB are (i) to make sure that banking facilities and services are in accordance with Islam, (ii) to guarantee that the bank's investments and involvement in projects are Sharia-conform and (iii) to ensure that the bank is managed in agreement with Islamic values.²³¹ In its articles of association the Faisal Bank of Egypt has stated that "A Religious Supervisory Board shall be formed within the Bank to observe conformance of its dealings and actions with the principles and rulings of Islamic Shariah."²³² The International Association of Islamic Banks (IAIB) has chosen a more scrupulously clarification of the duties imposed on its supervisory committee. In Article 2 of the Higher Board's Statute, IAIB has

²²⁷ Saeed, p.108.

²²⁸ Haron & Shanmugam, p.161.

²²⁹ Ibid, p.160.

²³⁰ Financial Times, 13 Nov 2001, "Survey: Site only – "Room for manoeuvre on the equities front - Like ethical funds, there is some side-stepping involved in finding shares that conform to the appropriate ethical standards", by Lydia Adetunji.

²³¹ Haron & Shanmugam, p.160.

²³² Ibid.

entrusted its SSB with the following duties:²³³ (i) to study fatwas previously issued, assess its consistency with the Sharia and when appropriate base its own rulings on these decisions, (ii) to supervise the activities of the bank in order to guarantee conformity with the Islamic law, (iii) to issue religious opinions on banking and financial questions, and (iv) to clarify legal religious rulings on new economic issues.

In practice, when Islamic banks face problems regarding the Sharia-compliance of their banking activities, the management will have to consult the SSB. However, prior to the board's assessment the management will itself have to analyse the complexity and suggest a solution to the problem. The main elements of the concept will then be clarified and an enlightening example will be provided. It is not until this procedure is completed that the SSB is to be consulted. The board will consider the suggestion presented by the bank and if there are any objections as to the conformity with Islamic law, the committee will also give its opinion and recommend a suitable solution and/or point to potential needs for modification.²³⁴

As has been established earlier, Muslims may only invest in companies, which engage in business activities that are halal (permitted). As regards the appraisal whether trade in various shares is tolerable or not from an Islamic point of view, the SSB plays a key role. Yet, such an evaluation is normally not the responsibility of every Islamic bank's own SSB (cooperative SSB), but this duty is rather entrusted with a centralised and independent SSB. In Malaysia for example, the Shariah Supervisory Council of the Securities Commission issues a 'List of Approved Securities', listing companies on the Kuala Lumpur Stock Exchange (KLSE) whose shares may be traded by Muslim investors as their business activities are considered to be halal. In 1999, more than five hundred companies of around seven hundred on the local exchanges were verified as Sharia-compatible.²³⁵

Another important task delegated to the SSB is the publishing of the religious audit in the bank's annual report. Nearly every Islamic bank employs its cooperative SSB to present a yearly appraisal of the businesses conducted by the bank to assure full consistency with Islam.²³⁶ For instance, the SSB of Bank Islam Malaysia, one of the leading Islamic banks in the country, in its annual report for 2001 concludes:²³⁷ "We... do hereby confirm on behalf of the members of the Council, that in our opinion, the operations of the Bank for the year ended 30 June 2001 have been conducted in conformity with the Shariah principles."

²³³ Ibid, p.161-162.

²³⁴ Saeed, p.108-109.

²³⁵ Rahman, Dato' Ahmad Tajudin Abdul.

²³⁶ Nida'ul Islam magazine (<http://www.islam.org.au>), "Principles of Islamic banking", published at <http://www.islam.org.au/articles/older/BANKING.HTM>

²³⁷ BIMB, [http://www.bankislam.com.my/ar/BIMB_Account%20\(Engl\).pdf](http://www.bankislam.com.my/ar/BIMB_Account%20(Engl).pdf)

9.2 The composition of the Board

As to the composition of the board this varies from one bank to another. Bank Islam Malaysia appoints five members meanwhile Faysal Islamic Bank of Bahrain is at ease with only three.²³⁸ As regards the members of the assembly some banks also stipulate that the SSB shall only be composed of members “believing in the idea of the Islamic Bank” (Article 40 of the Statutes of the Faisal Bank of Egypt) and typically there is a clause specifying the required competence.²³⁹ For instance, in article 40 of its Memorandum and Article of Association, Faysal Islamic Bank of Bahrain that, “the Board of Directors shall nominate, constitute and maintain a Religious Supervisory Board composed of at least three persons who are acknowledged experts in Islamic principles, laws and traditions.”²⁴⁰ Referring to the essential need for recognized proficiency, some Islamic banking experts are concerned about the deficiency as to necessary skills and sufficient knowledge. This is particularly a problem when conventional banks introduce Islamic banking services by setting up *Islamic windows*, because these banks, they say, may be tempted to appoint a more western-orientated SSB.²⁴¹

²³⁸ BIMB, http://www.bankislam.com.my/kenali_syariah_e.htm; Haron & Shanmugam, p.161.

²³⁹ Haron & Shanmugam, p.161.

²⁴⁰ Ibid.

²⁴¹ Ibid.

10 Conclusive remarks

Despite the September 11 attacks in New York, after which the words “Islam” and “finance” repeatedly have been associated with terrorist money laundering, the model of Islamic banking has firmly established its presence on the international market. For instance, one of the larger banks in the world, HSBC, launched a credit card and a home financing package for Muslims in the US just before the end of 2001.²⁴² Also, prospects for Islamic banking are said to be good in Europe, and especially in Bosnia where one of the larger commercial banks recently converted into an Islamic bank.²⁴³

To see a continuing growth in the Islamic banking industry more easily understood names must be given for the various instruments and techniques. Arabic tongue twisters like ‘Musharaka’ and ‘Murabaha’ ought to be replaced by ‘partnership financing’ and ‘cost plus profit sale’.²⁴⁴ In addition, Islamic banking laws are interpreted differently in different countries. Therefore, to sustain a continuing expansion in the Islamic banking industry, a uniform legal framework is of utmost urgency. Also, it has been held that growth must continue through mergers in order to face competition from large Western banks.²⁴⁵ None of the world’s top 100 banks are Islamic.²⁴⁶

Another obstacle is the undesirable impact that Islamic banking laws appear to have on various types of businesses, where small businesses are being discriminated for more profitable projects and ventures with larger firms. Such practices are truly dishonourable and must be dealt with.

A number of Islamic banking experts claim that no wholly Islamic banking market exists and that the likelihood that it ever will, is very little. Past attempts by the Jews and the Christians to abolish the employment of interest have always failed, because every time a black market for interest-bearing credits emerged, pushing the interest rates even higher. Furthermore, people would camouflage interest through dubious methods, for instance by utilising a sell-and-buy-back transaction.²⁴⁷ Today, the same problems are at hand.

²⁴² Financial Times, 13 Nov 2001, Survey: Site only – “Clients flock to call of the West – The Islamic arms of big global banks have been highly successful, yet few know how recent events will affect Muslim clientele”, by Lina Saigol.

²⁴³ Gulf News, 24 April 2002, “DIB, Adib to take stake in Bosnia Bank”, by Stanley Carvalho.

²⁴⁴ New Straits Times, 28 March 2002, “Using simple and clear terms in Islamic banking”, by Roziana Hamsawi.

²⁴⁵ Gulf News, 21 March 2002, “Consolidation vital’ for growth of Islamic banks”, by C.L. Jose.

²⁴⁶ New Horizon, No. 107, March 2001, “Muslim nations see growth in Islamic banking”.

²⁴⁷ New Horizon, No. 110, July 2001, “Eliminating interest from the Economy”, by Muhammad Akram Khan.

Currently, Islamic banking is carried out in a hybrid way, somewhere in between the paradigm version of Islamic banking and the more conventional system of Western banking.²⁴⁸ It is clear that the concept of Islamic banking is not well suited for modern and global banking activities. Yes, it is true that most Islamic banks have taken broad measures to adapt their activities to the modern economy, above all to compete with Western conventional banking. However, during this transition the Islamic banking industry has abandoned the very basics of Islam and many of the important principles have been twisted and are being executed in a Sharia-divergent way. Conclusively, it is truly questionable whether *genuine* Islamic banking, as it is carried out today, at all can be held to exist.

²⁴⁸ Errico & Farahbaksh, IMF Working Paper (WP/98/30).

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