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NUST Institute of Management Sciences

"RESEARCH STUDY ON ISLAMIC FINANCIAL SYSTEM

&

CAPITAL MARKETS

WITH FOCUS ON PAKISTAN STOCK MARKET"

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ABSTRACT

Recent surge in oil prices and production levels has created record levels of liquidity in the oil producing countries particularly in the GCC region. According to Standard and Poor estimates the investment-ready Arab capital now exceeds $2.3 trillion. Boston Consulting Group has also conducted a study of the accumulated wealth of the Middle Eastern investment entities and individual ruling families. Their estimate is that these entities are sitting on a combined asset pool of $10.2 trillion. Most of this wealth remains under the management of private banking departments of major western banks such as UBS, Cititgroup, Barclays, HSBC, and others. Even though several mega projects are being planned in the GCC countries, there simply are not enough viable projects for absorbing these surplus funds and channel them into productive private investment. Moderately industrialize Muslim countries such as Malaysia and Egypt offer the best potential for absorbing these surplus funds into profitable long-term investments. The historic opportunity exists for Islamic finance to tap this phenomenal liquidity and channel it into productive infrastructure and viable economic projects. This study provides an insight into various modules of Islamic economics and capital markets, which could be the most viable channel for such enormous fund, and could serve as a model for the analogous goal of islamization of financial and banking systems.

EXECUTIVE SUMMARY

Islamic finance industry has gone through a major transformation over the last quarter century with the adoption of various Shari'ah standards by IFSB, and multiple high academies operating under auspices of OIC, IDB, and other institutions. Most of this progress has been due to industry demand and reflects a growing consensus among the market participants to position themselves for long-term profitability. This consensus has also been made possible by the regulatory pressure to stay within the confines of an international monetary system, which promotes compliance with BASEL1 and BASEL II guidelines. Thus the twin objectives of Shari'ah compliance and adherence to basel guidelines have moved together to keep Islamic finance as part of the conventional mainstream. While there have been historical differences of opinion among Islamic jurists over many past centuries and the entire field of "muamalat" remains fragmented, the recent progress towards its convergence is remarkable for its wide acceptance. A robust banking and insurance industry enabled by sufficient liquidity has made it possible to achieve harmonization of practices among various parts of the world. But there is an element of specialization and relative concentration in various regions that requires careful analysis and application. The key to understanding these individual country practices is the adherence to a particular school of Shari'ah and the adoption of this school of thought by the Shari'ah boards of that country's banks, and central regulatory authorities. Most of the planners and regulators in the, Muslim countries have failed to develop meaningful projects from their agriculture, industrial and service sectors to avail the capital that is now abundantly available.

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Muslim communities limited banking activity, such as acceptance of deposits, goes back to the time when the Prophet Muhammad (PBUH) was still alive. At that time, people deposited money with the Prophet or with Abu Bakr Sedique, the First Khalif of Islam. The first modern Islamic bank, established in Egypt , was called **Nasser's Social Bank**.[1] Islamic accounting, an essential tool for the success of Islamic banks, is said to have been developed contemporaneously at the University of Cairo.

In contemporary world the desirability of abolishing fixed interest rates and the Islamization of financial systems were first discussed at the first meeting of the **Islamic Organization Conference (IOC) in Jeddah in 1973**. Subsequently, many Islamic financial institutions and banks were founded under the profit-and-loss sharing system (PLS), which will be discussed below.

The following research on Islamic financial system is an effort in the direction to identify the potential problems that are and may arise in implementing a complete and pragmatic Islamic economic system in Pakistan; that may serve as a model for other Islamic states that share the analogous goal of islamization of their financial and banking systems.

[1] Abdallah, A., 1987. 'Islamic banking', Journal of Islamic Banking and Finance, January-March, 4(1): 31-56.

In the real world, markets cannot be absolutely efficient or wholly inefficient. Markets are essentially a mixture of, daily decisions and events. They cannot be reflected immediately into a market; moreover, if all participants were to believe that the market is efficient, no one would seek extraordinary profits, the force that keeps the wheels of the market turning. However, in this study we would use the conceptual framework to gain an understanding of the efficiency of stock markets in Pakistan.

CHAPTER NO 1

INTRODUCTION

Islamic financial systems and interest-free banking, ideals long cherished by Muslims, have become reality. The growth of worldwide financial networks and of the reputation of Muslims for trustworthiness and trends toward revitalizing Islamic laws and economics, accompanied by substantial oil revenues have fostered expansion of Islamic banking. The proponents believe that, given the Islamic banks' achievements, attention should be focused on the control and reporting systems on which depositors, borrowers, and investors rely. More than 35 Islamic banks have sprung up across the 29 member states of the Islamic Organization Conference (IOC). There is an obvious need by Muslims for institutions in which they can deposit their savings, and borrow in accordance with Shariah principles (Islamic laws and regulations based on the Holy Quran and the Sunnah, i.e the preachings of the Prophet Muhammad). [2]The Kuwait Finance House (KFH) and the Bahrain Islamic Bank, as well as other Islamic banks, accept deposits from Muslim citizens of other countries, and there seems to be no explicit policy of refusing deposits from non-Muslims. Increasing sums are likely to be sought by Islamic banks for investment purposes because of the continuing expansion of the world's population, and the growing interdependence of nations.

Expansion of Islamic financial institutions is continuing at a rapid rate, especially in Saudi Arabia, Kuwait, and Bahrain. In Pakistan, Iran, and the Sudan, Islamic banking concepts have been reflected by government action: in Pakistan the government has ordered Islamization of banking practices; Iran has recently implemented an Islamic banking system; Sudan is applying Shariah to many of its economic activities. Internationally, two banking conglomerates, **Dar-al Maal Al-Islami (DMI)** and **Al-Baraka** and the **International Islamic Banking System (IBS)** have established Islamic branch banks in different countries of Asia, Europe and Africa. [3]

Some Islamic institutions have joined in international associations: the Islamic Bank International (IBI), the International Association of Islamic Banks (IAIB), and the International Federation of Islamic Banks (IFIB). IFIB has gained a measure of recognition by the United Nations' Conference on Trade and Development. The core missions of the associations are noteworthy. It is expected that they will provide training and technical and research support, and develop solutions to common problems facing Islamic banks and financial system.

Islamic banking operations are not limited to Arab soil, or Islamic countries, but are spreading throughout the world. One reason is the "growing trend toward transcending national boundaries, and unifying Muslims into a political and economic entity that could have a significant impact on the pattern of world trade.

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[2] Abdeen, A.M. and Shook, D.N., 1984. The Saudi Financial System, J. Wiley and Sons, Chichester

[3] Abdel-Magib, M.F., 1981. 'Theory of Islamic banks: accounting implications', International Journal of Accounting, Fall: 78-102.

Ali, M. (ed.) l982. Islamic Banks and Strategies of Economic Cooperation, New Century Publishers, London.

1.1 SCOPE OF STUDY

The following research on Islamic banking and financial system is an effort in the direction to identify the potential problems that are and may arise in implementing a complete and pragmatic Islamic financial system in Pakistan; that may serve as a model for other Islamic states that share the analogous goal of islamization of their financial and banking systems. Further an endeavor has been made to understand the very basics of Islamic financial system and review the impact of its growth over the industry.

CHAPTER 2

LITERATURE REVIEW

2.1 HISTORY OF ISLAMIC FINANCE

In Muslim communities, limited banking activity, such as acceptance of deposits, goes back to the time when the Prophet Muhammad (PBUH) was still alive. At that time, people deposited money with the Prophet or with Abu Bakr Sedique, the First Khalif of Islam. The first modern Islamic bank, established in Egypt , was called **Nasser's Social Bank**. Islamic accounting, an essential tool for the success of Islamic banks, is said to have been developed contemporaneously at the University of Cairo.

In contemporary world the desirability of abolishing fixed interest rates and the Islamization of financial systems were first discussed at the first meeting of the **Islamic Organization Conference (IOC) in Jeddah in 1973**. Subsequently, many Islamic banks were founded under the profit-and-loss sharing system (PLS), which will be discussed below.

Modern Islamic banking has undergone three phases of development:

- **Emergence-1972 through 1975:** This period was marked by a surge in oil revenues and great liquidity. Parallel events included a resurgence of fundamentalist Muslim movements, reemphasis on the Wahabi School of Brotherhood and Pan-Islamism, and establishment of IOC.
- **Expansion-1976 to the early 1980s:** Islamic banking spread from the Arabian Gulf eastward to Malaysia, and westward to England. More than 20 Islamic banks were established, including international and intercontinental institutions. Islamic banking associations or consultant bodies broadened their operations.
- **Maturity--1983 to the present**: The Arab world was confronted by economic setbacks, including slowdowns in oil revenues, the collapse of Kuwait's **Souk al-Manakh,** the relative strength of the U.S. dollar, higher interest rates in the United States, and capital outflows from OPEC nations. At the same time, Arab banks opened branches in the United States and Islamic banking practices were implemented in both Pakistan and Iran.

Islamic banking operations are not limited to Arab soil, or Islamic countries, but are spreading throughout the world. One reason is the "growing trend toward transcending national boundaries, and unifying Muslims into a political and economic entity that could have a significant impact on the pattern of world trade. [4]

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[4] Abdel-Magib, M.F., 1981. 'Theory of Islamic banks: accounting implications', International Journal of Accounting, Fall: 78-102.

Since Muslims are inclined to follow Islamic traditions, there is a tendency to establish an Islamic economic system in every Islamic nation. .. and to restore Shariah Law as the basic source for legislation" (Abdel-Magid, p. 81).

Further expansion is planned; for example, DMI has announced a five-year program to create a network of branches and subsidiaries in more than twenty countries. An American businessman of Iraqi origin plans to establish a U.S. based financial institution to be administered in accordance with Islamic banking practice. When approved by U. S. authorities, the institution will serve several million American Muslims.

2.2 EVOLUTION OF ISLAMIC FINANCIAL INSTITUTIONS

In seventies, such changes took place in the geo-political climate of Muslim countries that there was no longer felt any stanch need to establish Islamic Financial Institutions under cover. A number of Islamic Financial Institutions, both in letter and spirit, came into existence in the Middle East; Asia-Pacific region and Far -East were also not oblivious to the winds of change. The first Islamic Financial Institution in Malaysia was set up in l963, the **Muslim Pilgrims Savings Corporation,** to help people save for performing Hajj. In l969, this body evolved into the Pilgrims Management and Fund Board or the **Tabung Hajji**, as it is now popularly known. The Tabung Hajji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Shariah, but its role is rather limited, as it is a non-bank financial institution.[5] The success of the Tabung Hajji, however, provided the main impetus for augmentation of Islamic Financial Institutions all around the Muslim world.

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

2.3 RATIONALE

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

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[5] Mr.Qureshi “Islam and the Theory of Interest” (Qureshi l946)
Abdeen, A.M. and Shook, D.N., 1984. The Saudi Financial System, J. Wiley and Sons, Chichester

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

Some scholars have put forward economic reasons to explain why interest is banned in Islam. It has been argued, for instance, that interest, being a pre- determined cost of production, tends to prevent full employment.[6] In the same vein, it has been contended that international monetary crises are largely due to the institution of interest, and that trade cycles are in no small measure attributable to the phenomenon of interest. None of these studies, however, has really succeeded in establishing a causal link between interest, on the one hand, and employment and trade cycles, on the other. Others, anxious to vindicate the Islamic position on interest, have argued that interest is not very effective as a monetary policy instrument even in capitalist economies and have questioned the efficacy of the rate of interest as a determinant of saving and investment .A common thread running through all these discussions is the exploitative character of the institution of interest, although some have pointed out that **profit (which is lawful in Islam)** can also be exploitative. One response to this is that one must distinguish between profit and profiteering, and Islam has prohibited the latter as well.

2.4 SHARIAH PRINCIPLES

The prohibition of riba is mentioned in four different revelations in the Qur'an.

- The first revelation emphasizes that interest deprives wealth of God's blessings.
- The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others.
- The third revelation enjoins Muslims to stay clear of interest for the sake of their own welfare.
- The fourth revelation establishes a clear distinction between interest and trade, urging Muslims to take only the principal sum and to forgo even this sum if the borrower is unable to repay.

[6] Khan l968; Ahmad n.d.; Mannan l970
Ahmad, Sheikh Mahmud, l952. Economics of Islam, Lahore.

It is further declared in the Qur'an that those who disregard the prohibition of interest are at war with God and His Prophet. The prohibition of interest is also cited in no uncertain terms in the Hadith. The Prophet condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt.

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

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

“Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, and hand to hand...”.

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

2.5 ISLAMIC MODES OF FINANCING & ISLAMIC FINANCIAL INSTRUMENTS

The Islamic banks have an almost unlimited field to operate. They enter nearly all kinds of business, including project financing, working capital financing and export and import financing etc. The aforesaid book on Islamic banking and finance gives a list of Islamic modes of financing, on the basic of which the Islamic banks carry on their business. The same are briefly explained in the following paragraphs:

a). Musharaka (Partnership Financing)

The word ‘musharaka’ means a profit sharing joint venture, designed to limited production or commercial activities of long duration. In this case the bank and the customer contribute capital jointly. They also contribute managerial expertise and other essential services at agreed proportions. Profit or losses are shared according to the contract agreed upon. An individual partner does not become liable for the losses caused by others. Due to this joint venture this technique is also known as equity participation mode of investment. Profit is distributed according to a predetermined ratio and loss, if any is also shared according to the capital ratio. Both the bank and the customer take part in the management and control of the entrepreneurial activities. The term signifies a joint enterprise formed for conducting a business in which all partners share the profit according to an agreed ratio, while the loss (if any) is shared strictly according to the ratio of investment made by respective partners.

b). Mudarabah (Capital Financing)

This is a kind of partnership where one partner gives money to another to invest in a business. The other partner is responsible for running the business and management only. Profits earned in the business are shared between the partners in a pre-determined ratio. However, loss (if any) would be borne fully by the partner who invested the money, unless it had resulted from negligence on the part of the other partner. The liability of loss would, however, not exceed the amount of investment, in any case. Under the Capital Trust Financing or Mudaraba mode of financing, Islamic banks supplies the entire capital of the business and the customer gives his time and expertise, which form a relationship between the supplier of capital and the user of capital. Thus the bank and the customer work together and share profits and losses.

c). Diminishing Musharaka

In this case, a financier and his client participate in the joint ownership of a property or equipment or in a joint commercial enterprise. The share of the financier is divided into a number of units, which under an agreement are purchased by the client, one by one, until he purchases all the units of the financier.

d). Bai-Muajjal (Cost plus Sale under deferred payment)

The Bai-Muajjal mode of investment is as like as a Murabaha mode of investment with an exception that the sale under this cost-plus sale modes investment is made on a credit basis rather than cash. The main feature of this technique consists in procurement of goods at the request of the client and selling it to him on credit. This mode follows the same conditions as Murabaha mode of investment except the following:-

- i). The bank transfers the possession of goods to the client before payment.
- ii). In order to cover the sale price of the goods the bank obtains collateral securities from the client.
- iii). The bank normally takes property of Municipal area as mortgage. In case the client fails to repay the sale price the bank realize the amount by selling the mortgage property.

e). **Murabaha(Mark-up or Costs-Plus- Profit based financing)**

This mode of Murabaha sale connected to a promise is used by the Islamic banks which undertake the purchaser of commodities according to the specification requested by the customer. The bank then resells them on Murabaha to the one who promised to buy for its cost price plus a margin of profit agreed upon previously by the two parties. Under the Murabaha mode of investment the bank agrees to purchase for a client who will then reimburse the bank in a stated time period at an agreed upon profit margin. The mark-up price that the bank and the buyer agree to is mainly based on the market price of the commodity. Thus the bank earns a profit without bearing any risk.

Thus it is a kind of sale is which the seller expressly mentions the cost of the commodity for sale and sells it to a person by adding his profit on it. Thus, Murabaha is not a loan advanced on interest, but is the sale of a commodity for cash/deferred payment.

f). **Salam (Bai-Salam or Advance purchase)**

Under Bai-Salam mode of investment the bank purchases industrial and agricultural products in advance from their customers. The main features of this mode are:

- The price is normally paid with the execution of an agreement.
- According to the terms of agreement the bank receives the goods in due time

Banks and financial institutions for financing the agriculture sector can use this mode of financing. In Salam, the seller undertakes to sell specified goods to the buyer at a future date in exchange for a price, which is paid in advance. As pointed out earlier, the farmers at the time of the holy Prophet (peace be upon him) could not borrow money on interest after 'riba' was declared 'haram'. Therefore, the holy Prophet (PBUH) allowed them to sell their agricultural produce in advance.

g). **Istisna**

This is a sale transaction in which a commodity is transacted before it comes into existence. As a matter of fact, it is an order to a manufacturer to manufacture a specific commodity for the purchaser. The manufacturer uses his own material to manufacturer the specific product. In "Istisna", price is to be fixed with the consent of the concerned parties. All other necessary specifications about the commodity need, also, to be fully settled in advance.

h). Istijrar:

It means purchasing goods form time to time in different quantities under one master agreement, in which all the terms and conditions have been specified. In 'istijrar', the price is either determined in advance or it is determined after all the transactions of purchase are complete.

j). Ijarah (Leasing)

'Ijarah' means leasing. In this case owner transfers **usufruct** of his property to another person for an agreed period and for an agreed consideration. Since the ownership of the leased property remains with the lessor, all the liabilities emanating from such ownership are to be borne by the lessor.. Thus, leasing purchase is another technique followed by Islamic banks in financing customers. This system is almost similar to the leasing activity provided in traditional banking. Leasing is a contract between the bank and the customer to use particular assets. In this case the bank is called lessor and the customer is called lessee who wants to use the assets and pays rent. Su'ud (1990), in this regard argued that the leasing agreement is based on profit sharing in which the bank buys the movable or immovable property and lease it to one of its client for an agreed sum by installments and for a limited period of time into a saving account held with the same bank. [7]These installments are invested in Mudaraba investment (Venture) for the customer's account. The accumulated profit generated from the payments, and the payments themselves are invested in the bank's investment ventures over the time period of lease, contributing to eventual purchase of the leased assets

k). Ijarah WA Iqtina (Leasing Purchase)

It is a form of leasing, where the lessor signs a separate promise to give the leased property to the lessee at the end of the lease period, subject to his paying the entire amount of rent as per the agreement. According to the Western leasing system the lessee pays specific rentals and a fixed rate of interest over a given period for the use of specific assets. But in the Islamic banking system of leasing the risk related to leasing has to be shared between the bank and the lessee, in case of any damage to the leased assets. The contract is called **'ijara-wa-iqtina'** i.e. leasing purchase, when the ownership of the assets is transferred to the clients after the completion of the leasing contract.

l). Hire-Purchase investment under Shirkatul Meelk

Islamic banks in Bangladesh also invest funds under Hire-Purchase mode. Under this investment technique the bank sells building, transport and other valuable items to the

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[7] Khan l968; Ahmad n.d.; Mannan l970
Ahmad, Sheikh Mahmud, l952. Economics of Islam, Lahore
Su'ud, M. Abu, n.d. 'The economic order within the general conception of the Islamic way of life', Islamic Review, London, 55 (2): 24-26 and (3): ll-l4.

client. The value of hire-purchase amount is payable in installments. When the client pays back the value of the goods including rent, the ownership is transferred to him.

m). Quard E Hasana

Quard E Hasana means an interest-free loan given by the Islamic bank to the needy people in a society. The practice of dealing with this sort of investment differs from bank to bank. Quard E Hasan is normally given to needy students, small producers, farmers, entrepreneurs and economically weaker sections of the society, who are not in a position to obtain loan or any financial assistance from any other institutional sources. The main aim of this loan is to help needy people in a society in order to, make them self-sufficient and to raise their income and standards of living.

n). Interest free

The avoidance of interest has been abused by those who merely seek to be seen to be Islamic bankers. Many convert interest into capital gains and find a Qu'ranic justification. The rules have been tightened progressively as they have been in tax avoidance.

o). Trade related

It is unfair to criticize devices converting interest to capital gains as all such instruments have to show some underlying commercial need and therefore probably go some way towards the Islamic objectives. There are Western parallels with Commercial paper and Bankers Acceptances which also have to be trade related. Many emerging markets, under their exchange control regimes, insist that all overseas financing or foreign exchange transactions have to be trade related.

p). Equity related

It has been suggested that 'pure Islamic banking' involves profit and loss sharing or equity participation in the Mudaraba and Musharaka forms. There is no pre-determined interest income for the lender or, in this case, the investor. The investor's return is uncertain: Sounds good and just the sort of venture capital financing many in the West have been demanding of their risk-averse banks.

Devices can be created so that pre-determined interest can be made to look like pre-determined capital gains. Also a tiny bit of uncertainty may be introduced into the equation. But there is also a requirement to avoid exploitation. If under a profit-sharing arrangement, because of the entrepreneur's poor bargaining position and the banker's monopoly status, the bank received 95 per cent of a venture' profits. Would this be deemed Islamic? Perhaps there do not appear to be rules that determine fair sharing ratios of profits.

q). Islamic Derivatives

It is generally assumed that the term Islamic Derivatives is a contradiction. The requirements of derivatives and rules of Shariah, at first sight, are diametrically opposed and all derivatives are therefore Haram. But it is important to recall the generalised definition in use of a financial derivative. It is simply a financial instrument that is derived from another financial instrument or a combination of such instruments. It is argued that as derivatives unquestionably involve interest or interest-based products they are contaminated and should be prohibited. Derivatives only involve interest if one or both parties using the derivative seeks to hedge the derivative.[8] It could be argued that Murabaha could involve interest if the parties seek to match the interest free but guaranteed return product with an interest-bearing equivalent. Islamic banking derivatives should be perfectly acceptable so long as they do not involve interest.

In Malaysia there is a dual financial system. An Islamic banking system works alongside a conventional interest bearing banking system. But there is only one purely Islamic bank compared with 26 dual system banks offering Islamic windows. These dual system banks do not completely separate the Islamic banking units from the rest of the bank and there is inevitably a crossover of the effects of derivatives from the conventional system into the Islamic system. Most of the research into the acceptability of Islamic derivatives has been accordingly carried out in Malaysia. There have also been developments in Bahrain.

Baisalam, which involves pre-payment for goods, is indeed an Islamic banking derivative and can be regarded as a kind of forward contract. Options are just insurance policies. Just as Takaful is an acceptable Islamic form of Insurance, options for delivery of commodities by a producer of such a commodity should be acceptable. So also should options or forward contracts on any of the Islamic financial instruments mentioned.

The acid test seems to be the presence or otherwise of an underlying trade transaction to justify the derivative transaction. There will undoubtedly be developments that attempt to make Islamic derivative contracts look and feel like non-derivative contracts. The process is similar to that in the early days of derivatives. There was a problem with the tax treatment of FRA's. A synthetic FRA was created to overcome the problem. Such a product could be tweaked to serve as an Islamic derivative.

It will be a long time before Islamic derivatives are deemed to be acceptable. The developments will prove to be very similar to the developments in derivatives in the late 1970s. The Islamic banking derivatives winners will be those who remember or research into financial history rather than the rocket scientists.

2.6 IS CAPITAL COST-LESS IN ISLAM?

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[8] Abdel-Magib, M.F., 1981. 'Theory of Islamic banks: accounting implications', International Journal of Accounting, Fall: 78-102.

Uzair, Mohammad, l955. An Outline of `Interestless Banking', Raihan Publications, Karachi.

The Islamic ban on interest does not mean that capital is costless in an Islamic system. Islam recognizes capital as a factor of production, but it does not allow the factor to make a prior or pre-determined claim on the productive surplus in the form of interest. This obviously poses the question as to what will then replace the interest rate mechanism in an Islamic framework. There have been suggestions that profit-sharing can be a viable alternative (Kahf l982a and l982b). In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit- sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself that is predetermined. [9]

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

2.7 LITERATURE SURVEY: ISLAMIC BANK & ISLAMIC CAPITAL

It is not possible to cover in this survey all the publications, which have appeared on Islamic Banking and Finance however there are numerous publications in Arabic and Urdu, which have made significant contributions to the theoretical discussion. A brief description of these can be found in the following discussions.

The early contributions on the subject of Islamic banking and Islamic capital were somewhat casual in the sense that only passing references were made to it in the discussion of wider issues relating to the Islamic economic system as a whole. In other words, the early writers had been simply thinking aloud rather than presenting well-thought-out ideas. Thus, for example, the book by Mr.Qureshi "**Islam and the Theory of Interest"** (Qureshi l946) looked upon banking as a social service that should be sponsored by the government like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit-sharing.[10]

Mr.Ahmad, in Chapter VII of his book **"Economics of Islam**" (Ahmad l952), envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or

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[9] Mr.Qureshi "Islam and the Theory of Interest" (Qureshi l946)
Choudhury, Masul Alam, l986. Contributions to Islamic Economic Theory: A Study in Social Economics, St Martin Press, New York.
[10] Al-Arabi, Mohammad Abdullah, l966. 'Contemporary banking transactions and Islam's views thereon', Islamic Review, London, May l966: l0-l6.

interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any.

Al-Arabi (l966) envisaged an Islamic system with mudaraba as the main pivot. He was actually advancing the idea of a **two-tier mudaraba** which would enable the bank to mobilize savings on a mudaraba basis, allocating the funds so mobilized also on a mudaraba basis. In other words the bank would act as a **mudarib** in so far as the depositors were concerned, while the **'borrowers'** would act as mudaribs in so far as the bank was concerned. In his scheme, the bank could advance not only the capital procured through deposits but also the capital of its own shareholders. It is also of interest to note that his position with regard to the distribution of profits and the responsibility for losses was strictly in accordance with the Shariah.[11]

Mr.Irshad (l964) also spoke of mudaraba as the basis of Islamic banking, but his concept of mudaraba was quite different from the traditional one in that he thought of **capital and labour (including entrepreneurship**) as having equal shares in output, thus sharing the losses and profits equally. This actually means that the owner of capital and the entrepreneur have a fifty-fifty share in the profit or loss as the case may be, which runs counter to the Shariah position. Irshad envisaged two kinds of deposit accounts. The first sounded like current deposits in the sense that it would be payable on demand, but the money kept in this deposit would be used for social welfare projects, as the depositors would get zero return. The second one amounted to term deposits, which would entitle the depositors to a share in the profits at the end of the year proportionately to the size and duration of the deposits. He recommended the setting up of a Reserve Fund, which would absorb all losses so that no depositor would have to bear any loss. According to him, all losses would be either recovered from the Reserve Fund or borne by the shareholders of the bank.

A pioneering attempt at providing a fairly detailed outline of Islamic banking and capital was made in Urdu by Mr. Siddiqi in l968. (The English version was not published until l983.) His Islamic banking model was based on **mudaraba** and **shirka** (partnership or musharaka as it is now usually called). His model was essentially one based on a two-tier mudaraba financier-entrepreneur relationship, but he took pains to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic

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[11] Ahmad, Sheikh Mahmud, l952. Economics of Islam, Lahore

Ali, M. (ed.) l982. Islamic Banks and Strategies of Economic Cooperation, New Century Publishers, London

Al-Arabi, Mohammad Abdullah, l966. 'Contemporary banking transactions and Islam's views thereon', Islamic Review, London, May l966: l0-l6.

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examples. He classified the operations of an Islamic bank into three categories: services based on fees, commissions or other fixed charges; financing on the basis of mudaraba and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

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

Strangely, Siddiqi favoured keeping the number of shareholders to the minimum, without advancing any strong reasons. This is contrary to the general consensus, which now seems to have emerged with reference to Islamic banks operating on a joint stock company basis, a consensus that incidentally is also in line with the Islamic value attached to a broad equity base as against heavy concentration of equity and wealth. Ironically, Chapra's model of Islamic banking, like Siddiqi's, was based on the mudaraba principle. His main concern, however, centered on the role of artificial purchasing power through credit creation. He even suggested that 'seignior age' resulting from it should be transferred to the public exchequer, for the sake of equity and justice. He was also much concerned about the concentration of economic power, private banks might enjoy in a system based on equity financing. He therefore preferred medium-sized banks, which are neither as large as to wield excessive power nor so small as to be uneconomical.[12] The scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. He also spoke of non-bank financial institutions, which specialize in bringing financiers and entrepreneurs together and act as investment trusts.

Mohsin (l982) has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by banking business alone. Many of the activities listed

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[12] Chapra, M. Umer, l982. 'Money and banking in an Islamic economy' in M Ariff (ed.), above.

Mohsin, M., l982. 'Profile of riba-free banking', in M. Ariff (ed.), above.

certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. His model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that riba-free banks could coexist with interest-based banks.[13]

He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of riba, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a **social-welfare-oriented** rather than a **profit-maximizing role**. He conceived of Islamic banks as a crossbreed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers. Unlike conventional banks, which depend heavily on the 'crutches of collateral and of non-participation in risk, Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing. Thanks to the profit-and-loss sharing nature of the operations, bank-customer relations would be much closer and more cordial than is possible under conventional banking.

The literature also discusses the question of central banking in an Islamic framework. The general opinion seems to be that the basic functions of a modern central bank are relevant also for an Islamic monetary system, although the mechanisms may have to be different. Thus, for example, the bank rate instrument cannot be used as it entails interest. Uzair (l982) has suggested adjustments in profit-sharing ratios as a substitute for bank rate manipulations by the central bank. Thus, credit can be tightened by reducing the share accruing to the businessmen and eased by increasing it. Siddiqi (l982) has suggested that variations in the so-called **'refinance ratio'** (which refers to the central bank refinancing of a part of the interest-free loans provided by the commercial banks) would influence the quantum of short-term credit extended. Siddiqi has also proposed a prescribed **'lending ratio'** (i.e., the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) that can be adjusted by the central bank according to changing circumstances. In this context, reference may also be made to a proposal by Uzair (l982) that the central bank should acquire an equity stake in commercial banking by holding, say, **25 per cent of the Capital stock** of the commercial banks.[14] The rationale behind this proposal was that it would give the central bank access to a permanent source of income so that it could effectively act as lender of last resort. The discussion of central banking in an Islamic context is somewhat scanty, presumably

[13] Mohsin, M., l982. 'Profile of riba-free banking', in M. Ariff (ed.),
Naqvi, S.N.H., l98l. Ethics and Economics: An Islamic Synthesis, The Islamic Foundation, Leicester

[14] Uzair, Mohammad, l955. An Outline of `Interestless Banking', Raihan Publications, Karachi.

Nienhaus, V., l983. 'Profitability of Islamic PLS banks competing with interest banks: problems and prospects', Journal of Research in Islamic Economics, l(l):37-47.

because Islamic central banking is viewed as too far-fetched an idea, except in Iran and Pakistan.

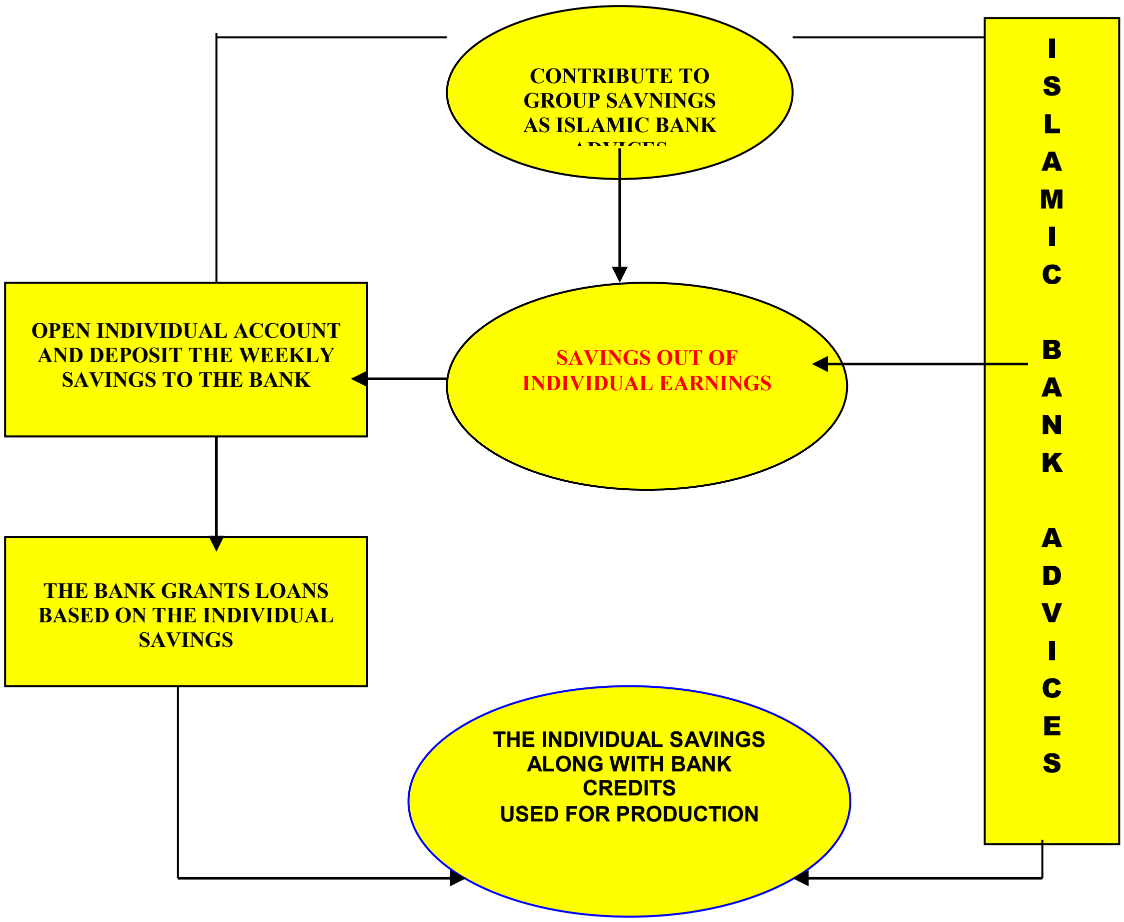
Thus, there is a near-consensus that Islamic banks and capital markets can function well without interest. A recent International Monetary Fund study has found Islamic banking and economics, to be a viable proposition that can result in efficient resource allocation. The study suggests that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts. The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope. But it is undeniable that the multipurpose character of Islamic banking and capital markets, poses serious practical problems, especially in relation to the skills needed to handle such diverse and complex transactions.

The stress on equity-oriented transactions in Islamic banking and economics, especially the mudaraba mode, has been criticized. It has been argued that the replacement of pre-determined interest by uncertain profits is not enough to render a transaction Islamic, since profit can be just as exploitative as interest is, if it is 'excessive' (Naqvi l98l). Naqvi has also pointed out that there is nothing sacrosanct about the institution of mudaraba in Islam. He maintains that **mudaraba is not based on the Qur'an or the Hadith but was a custom of the pre-Islamic Arabs**. Historically, mudaraba, he contends, enabled the aged, women, and children with capital to engage in trade through merchants for a share in the profit, all losses being borne by the owners of capital, and therefore it cannot claim any sanctity. The fact remains that the Prophet raised no objection to mudaraba, so that it was at least not considered un-Islamic.[15]

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

[15] Mohsin, M., l982. 'Profile of riba-free banking', in M. Ariff (ed.),
Naqvi, S.N.H., l98l. Ethics and Economics: An Islamic Synthesis, The Islamic Foundation, Leicester.

Figure 3: Process of developing saving habit by Bai-Muajjal financing



Institutionalization of saving habits through lending process[16]

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[16] Zaidi, N.A., l987. 'Profit rates policy for PLS depositors', Journal of Islamic Banking and Finance, 4 (4): 35-46.

CHAPTER 3

EMPIRICAL STUDIES:ISLAMIC CAPITAL MARKETS & BANKING

3.1EQUITY BASED-INVESTMENT AND ELIMINATION OF INTEREST

Considering interest in Islamic economics Ahmad (1994), argues that elimination of interest does not mean zero-return on capital rather Islam forbids a fixed predetermined return for a certain factor of production i.e. one party having assured return and the whole risk of an entrepreneurship to be shared by others. The author also observed that it is the capital entrepreneurship that shares both the real contribution and the real profitability. The Islamic bank follows the principle of ***equity based-investment***. The Islamic capital system also proposes that resources can be contracted on the basis of venture capital and risk sharing deals. The idea of equity-based investment banking is not new to the financial market. If we look into history it may be observed that capital, as loan capital as well as venture capital played a great role in promoting industrial and economic development of various countries of the world. For example, during the 19th and 20th centuries investment banks played a great role in French tradition while in British model of banking equity-based investment was limited. Similarly in Germany equity-based investment was being practiced by commercial banks during that period. Even the banking crisis in the western world during the great depression in the 30's or the 80's proposed two-tire banking i.e. hundred percent deposit banking and the equity-based investment banking. [17]

In his article entitled "elimination of Riba" Ahmad while quoting a leading German economist Professor Haus Alba'ch's observation regarding Islamic the author mentioned 'Islamic banks belong to the class of equity participation banks. They supply equity in the form of venture capital to investors whose share is their ingenuity and their labor. Secondly, they supply equity in the form of equity capital as participants in the type of project, which in general has a majority shareholder. [18]They may be ideally suited to meet the need for equity capital in developing countries where the business risk is particularly high as well as in the industrialised countries where the development of new processes and new projects involves high risk and requires large amount of venture capital' (Islamic banking, proceedings of the Baden-Baden seminar, London).

Recent years have brought an increasing flow of empirical studies of Islamic banking and capital markets. Mr.Khan undertook the earliest systematic empirical work, back in l983. His observations covered Islamic banks operating in Sudan, United Arab Emirates, Kuwait, Bahrain, Jordan, and Egypt. Khan's study showed that these banks had little

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[17] Ahmad, Sheikh Mahmud, l952. Economics of Islam, Lahore.

n.d. 'Interest and Unemployment', Islamic Studies, Islamabad, VIII (l): 9-46.

[18] (ed.) 1984. Papers on Islamic Banking, New Century Publishers, London

difficulty in devising practices in conformity with Shariah. He identified two types of investment accounts:

a) where the depositor authorized the banks to invest the money in any project and;
b) the other, where the depositor had a say in the choice of project to be financed.

On the asset side, the banks under investigation had been resorting to mudaraba, musharaka and murabaha modes. Khan's study reported profit rates ranging from 9 to 20 per cent, which were competitive with conventional banks in the corresponding areas. The rates of return to depositors varied between 8 and l5 percent, which were quite comparable with the rates of return offered by conventional banks.

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

The **IMF study** (Iqbal and Mirakhor) also contains extremely interesting empirical observations, although these are confined to the experience of Iran and Pakistan, both of which have attempted to Islamize the entire banking system on a comprehensive basis. Iran switched to Islamic banking in **August l983** with a three-year transition period. The Iranian system **allows banks to accept current and savings deposits without having to pay any return, but it permits the banks to offer incentives such as variable prizes or bonuses in cash or kind on these deposits.** Term deposits (both short-term and long-term) earn a rate of return based on the bank's profits and on the deposit maturity. No empirical evidence is as yet available on the interesting question as to whether interest or a profit-share provides the more effective incentive to depositors for the mobilization of private saving.[19] Where Islamic and conventional banks exist side-by-side, central bank control of bank interest rates is liable to be circumvented by shifts of funds to the Islamic banks.

Iqbal and Mirakhor have noted that the conversion to Islamic modes has been much slower on the asset than on the deposit side. It appears that the Islamic banking system in Iran was able to use less than half of its resources for credit to the private sector, mostly in the form of short-term facilities, i.e., commercial and trade transactions. The slower pace of conversion on the asset side was attributed by the authors to the inadequate supply of personnel trained in long-term financing. The authors, however, found no evidence to show that the effectiveness of monetary policy in Iran, broadly speaking, was altered by the conversion. [20]

The Pakistani experience differs from the Iranian one in that Pakistan had opted for a gradual islamization process, which began **in l979.** In the first phase, which ended on l

[19] Iqbal, Zubair and Mirakhor, Abbas, l987. Islamic Banking, International Monetary Fund Occasional Paper 49, Washington D.C.

[20] Mirakhor, Abbas, 1986. 'Some theoretical aspects of an Islamic financial system', paper presented at a Conference on Islamic Banking sponsored by the Central Bank of the Islamic Republic of Iran, Tehran, 11-14 June

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

The IMF study, however, expressed considerable uneasiness about the concentration of bank assets on short-term trade credits rather than on long-term financing. This the authors found undesirable, not only because it is inconsistent with the intentions of the new system, but also because the heavy concentration on a few assets might increase risks and destabilize the asset portfolios. The study also drew attention to the difficulty experienced in both Iran and Pakistan in financing budget deficits under a non-interest system and underscored the urgent need to devise suitable interest-free instruments. Iran has, however, decreed that **government borrowing on the basis of a fixed rate of return from the nationalized banking system would not amount to interest and would hence be permissible.** The official rationalization is that, since all banks are nationalized, interest rates and payments among banks will cancel out in the consolidated accounts. (This, of course, abstracts from the banks' business with non-bank customers.) There are also some small case studies of Islamic banks operating in Bangladesh (Huq l986), Egypt (Mohammad l986), Malaysia (Halim l988b), Pakistan (Khan l986), and Sudan (Salama l988b). These studies reveal interesting similarities and differences. The current accounts in all cases are operated on the principles of **al-wadiah**. Savings deposits, too, are accepted on the basis of al-wadiah, but 'gifts' to depositors are given entirely at the discretion of the Islamic banks on the minimum balance, so that the depositors also share in profits. Investment deposits are invariably based on the mudaraba principle, but there are considerable variations.[21] Thus, for example, the Islamic Bank of Bangladesh has been offering PLS Deposit Accounts, PLS Special Notice Deposit Accounts, and PLS Term Deposit Accounts, while Bank Islam Malaysia has been operating two kinds of investment deposits, one for the general public and the other for institutional clients.

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

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[21] Khan, Abdul Jabbar, l986. 'Non-interest banking in Pakistan: a case study', paper presented to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.

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

The two main problems identified by the case studies are the **absence of suitable non-interest-based financial instruments for money and capital market transactions and the high rate of borrower delinquency**. The former problem has been partially redressed by Islamic banks resorting to mutual inter-bank arrangements and central bank cooperation, as mentioned earlier. The Bank Islam Malaysia, for instance, has been placing its excess liquidity with the central bank, which usually exercises its discretionary powers to give some returns. The delinquency problem appears to be real and serious. Murabaha payments have often been held up because late payments cannot be penalized; in contrast to the interest system in which delayed payments would automatically mean increased interest payments. To overcome this problem, the Pakistani banks have resorted to what is called **'mark-down'** which is the opposite of 'mark-up' (i.e., the profit margin in the cost-plus approach of murabaha transactions). 'Mark-down' amounts to giving rebates as an incentive for early payments. But the legitimacy of this 'mark-down' practice is questionable on Shariah grounds, since it is time- based and therefore smacks of interest.[22]

In the Southeast Asian context, two studies on the **Bank Islam Malaysia by Man (l988) and the Philippine Amanah Bank by Mastura (l988)** deserve special mention. The Malaysian experience in Islamic banking has been encouraging. Man's study shows that the average return to depositors has been quite competitive with that offered by conventional banks. By the end of l986, after three years of operation, the bank had a network of fourteen branches. However, 90 per cent of its deposits had maturities of two years or less, and non-Muslim depositors accounted for only 2 per cent of the total. Man is particularly critical of the fact that the mudaraba and musharaka modes of operation, which are considered most meaningful by Islamic scholars, accounted for a very small proportion of the total investment portfolio, while bai'muajjal and ijara formed the bulk of the total. It is evident from Mastura's analysis that the Philippine Amanah Bank is, strictly speaking, not an Islamic bank, as interest-based operations continue to coexist with Islamic modes of financing. Thus, the PAB has been operating both interest and Islamic 'windows' for

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[22] Salama, Abidin Ahmad, l986. 'Utilisation of financial instruments: a case study of Faisal Islamic Bank (Sudan)', paper submitted to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.

deposits. Mastura's study has produced evidence to show that the PAB has been concentrating on murabaha transactions, paying hardly any attention to the mudaraba and musharaka means of financing. The PAB has also been adopting unorthodox approaches in dealing with excess liquidity by making use of **interest- bearing treasury bills**. Nonetheless, the PAB has also been invoking some Islamic modes in several major investment activities. Mastura has made special references to the **qirad** principle adopted by the PAB in the Kilu-sang Kabuhayan at Kaunlaran (KKK) movement launched under Marcos and to the ijara financing for the acquisition of farm implements and supplies in the Quedon food production program undertaken by the present regime. So far no reference has been made to Indonesia, the largest Muslim country in the world, with Muslims accounting for 90 per cent of a population of some 165 million. The explanation is that a substantial proportion, especially in Java, are arguably nominal Muslims. Indonesians by and large subscribe to the **Pancasila ideology**, which is essentially secular in character. The present regime seems to associate Islamic banking with Islamic fundamentalism to which the regime is not at all sympathetic. Besides, the intellectual tradition in Indonesia in modern times has not been conducive to the idea of interest-free banking. There were several well-respected Indonesian intellectuals including Hatta (the former Vice President) who had argued that riba prohibited in Islam was not the same as interest charged or offered by modern commercial banks, although Islamic jurists in Indonesia hold the opposite view. The Muslim public seems somewhat indifferent to all this. This, however, does not mean that there are no interest-free financial institutions operating in Indonesia. One form of traditional interest-free borrowing is the still widely prevalent form of informal rural credit known as **ijon (green)** because the loan is secured on the standing crop as described by Partadireja (1974). Another is the **arisan system** practiced among consumers and small craftsmen and traders. In this system, each member contributes regularly a certain sum and obtains interest-free loans from the pool by drawing lots.[23]

Finally, comparatively in recent contribution to the growing Islamic banking literature, **Nien-haus (l998)** concludes that Islamic banking is viable at the microeconomic level but dismisses the proponents' ideological claims for superiority of Islamic banking as 'unfounded'. Nienhaus points out that there are some failure stories. Examples cited include the **Kuwait Finance House** which had its fingers burned by investing heavily in the Kuwaiti real estate and construction sector in l984, and the Islamic Bank International of Denmark which suffered heavy losses in l985 and l986 to the tune of more than 30 per cent of its paid-up capital. But then, as Nienhaus himself has noted, the quoted troubles of individual banks had specific causes and it would be inappropriate to draw general conclusions from particular cases. Nienhaus notes that the high growth rates of the initial years have been falling off, but he rejects the thesis that the Islamic banks have reached their 'limits of growth' after filling a market gap. The falling growth rates might well be due to the bigger base values, and the growth performance of Islamic banks has been relatively better in most cases than that of conventional banks in recent years.

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[23] Partadireja, Ace, 1974. 'Rural credit: the Ijon system', Bulletin of Indonesian Economic Studies, 10 (3): 54-71.

Nienhaus, V., l983. 'Profitability of Islamic PLS banks competing with interest banks: problems and prospects', Journal of Research in Islamic Economics, l(l):37-47.

According to Nienhaus, the market shares of many Islamic banks have increased over time, notwithstanding the deceleration in the growth of deposits. The only exception was the Faisal Islamic Bank of Sudan (FIBS) whose market share had shrunk from l5 per cent in l992 to 7 per cent in l996, but Nien-haus claims that the market shares lost by FIBS were won not by conventional banks but by newer Islamic banks in Sudan. Short-term trade financing has clearly been dominant in most Islamic banks regardless of size. This is contrary to the expectation that the Islamic banks would be active mainly in the field of corporate financing on a participation basis. Nienhaus attributes this not only to insufficient supply by the banks but also to weak demand by entrepreneurs who may prefer fixed interest cost to sharing their profits with the banks.[24]

3.2 CHARACTERIZING THE ORGANIZATIONAL FIELDS AS MAJOR FINANCING SYSTEMS (MFS)

The organizational field in the theoretical framework consists of two institutions such as the Major Financing Systems (MFS) and Small and Cottage Industry Systems (SCIS). The major financing systems (MFS), which is the subject matter of the discussion in this chapter again consists of two different financing systems. These are for example, the Islamic Financing System (IFS) and the Market-Based Financing System (MBFS). The financing organizations of similar nature are grouped within these two financing systems. In order to study differences between Islamic banks and other conventional banks from the viewpoint of the Institutional-Network theoretical framework, in the present study the IFS (Islamic Financing System) and MBFS (Market-Based Financing System) are regarded as distinct market-hierarchy institutions in the financial and the organizations within these systems .

3.3 THE MARKET-BASED FINANCING SYSTEMS (MBFS)

The market-based financing system includes various financing organizations, which are organized, controlled and owned either by the government or by the private individuals. Government and privately owned financing organizations follow various rules and regulations which in many respects are inspired by the Western financing organizations. These organizations extend credit facilities to large as well as medium size industries and also maintain financial relationships with various market-based financing organizations abroad. From that viewpoint, these sorts of organizations are identified and included in the market-based financing system. Financing organizations relates to the MBFS includes both the government and the privately owned commercial banks.

a). The Islamic Financing Systems (IFS) The Islamic Financing System (IFS) includes different financing organizations that are guided by ***shariah*** (Islamic law) based financing principles. These organizations use different financing techniques and lending procedures than those in the other financing systems. The IFS is a mix of market-based and non market-based financing systems. Although many exchange functions in

[24] Nienhaus, V., l983. 'Profitability of Islamic PLS banks competing with interest banks: problems and prospects', Journal of Research in Islamic Economics, l(l):37-47
Rahardjo, Dawam, 1988. 'Islamic banking in Indonesia?' in M. Ariff (ed.)

organizations within the IFS are similar to those of western inspired commercial banks, they are also based on non-market rules and regulations, which are purely based on religious ethics. The organizations in the IFS function beyond the market-based economy, since the exchange relations of this system, are mainly ethics based originating from religious beliefs, trust and faith. Religious norms/values and beliefs regulated human behavior in society long before modern market began. In the past, people found religion as a means of worship or approach to God, simply a personal matter. Thus, by taking fundamentals of religion as the instruments, the organizations in this financing system bridge the gap between a market economy and a traditional system.

b). Characteristics of the Components of Major Financing Systems (MFS)

It is mentioned in the above section that like Whitley's (1992b) 'Business Systems' different financing systems (e.g. the Islamic and the conventional financing system) are outlined as distinct ways of organizing economic activities in a market society and identified the major characteristics, according to which financing systems vary between institutional contexts. The characteristics of the components of Whitley's (1992b)[25] 'Business System' are developed while structuring Institutional-Network framework with a view to studying differences in the economic activities between Islamic banks and other conventional banks. The components or major characteristics of these financing systems are: the nature of dominant economic activities and resources, the structure of market relations, the nature of authoritative coordination and control systems and employment systems. These components of the financing systems are again analyzed in terms of a number of sub characteristics, which forms the basis for comparison across institutional contexts. These are mentioned below:

The Nature of the organization of the financing system

- Managerial discretion from owners
- Managerial homogeneity
- Growth focus
- Risk management
- Ownership

Market Organization

- Information process
- Interdependence of lender-borrower
- Commitment to particular exchange partner
- Incentives to employees

[25] Ali, M. (ed.) l982. Islamic Banks and Strategies of Economic Cooperation, New Century Publishers, London
Khan, W.M., l985. Towards an Interest-Free Islamic Economic System, The Islamic Foundation, Leicester

Employment systems

- Recruitment procedures
- Boss subordinate relationship
- Job training
- Seniority based rewards

Authority and control systems

- Centralization of decision-making
- Delegation of authority
- Reliance on formal coordination and control
- Managerial involvement in work group

Table: I Differences in the nature of the MFS

Characteristics	IFS	MBFS
Size: No. of customers	Medium	Large
Ownership	Local/Foreign	Local shareholders
Degree of managerial discretion from owners	High	Low
Business specialization and managerial homogeneity	High	Medium
Integration of different activities	High	Medium
Growth focus	Short term profit goal	Short/long term profit goal
Risk management	High/internal//Medium external	Low Internal/Low external

Legend. IFS: Islamic financing system; MBFS: market-based financing system;

3.4 RISK MANAGEMENT IN ISLAMIC FINANCING SYSTEM

Risk management is closely related to risk sharing, which may be either, internal or external in nature. Externalization of risk by an organization may be done through developing close ties between suppliers, customers, and other interest groups in an organizational field. Whitley (1992a) also indicated that long-term relations of mutual dependence stand as one contributing factor to the risk management in an organization. Internalization of risk means that the financing organizations bear the risk. [26]

Risk is very much a perception. Difference in risk perception is a result of better understanding and ability, or capability, to handle the type of risk. Distance to the actual risk decreases real knowledge and understanding of that risk and hence increases ones perception of that risk. This is clearly evident in the fact that the Northern American market is the most competitive provider of funds to the Latin American market, while Western Europe is the most competitive provider of capital to Eastern Europe; similarly Japan to Asia and so on. This is also true of the Islamic market and the Middle East, North Africa and the Near East.

It is known from the study that in the case of organizations in the Islamic Financing System, the junior and the senior staff jointly share the responsibilities. The risk is, thus, shared between higher and lower level management. In organizations within the Market-Based Financing System, due to centralization of power and authority, the sharing of internal risk is lower compared to the organizations in the IFS. It is therefore concluded that risk management in the organizations in the IFS is characterized by a higher degree of internal risk sharing compared to those in the other financing systems.

Regarding the externalization of risk it is understood from the study that the lending activities of organizations within the IFS are characterized by close lender-borrower relationships. Apart from lending funds they also act as guides to the borrowers. This results in the increase of the externalization of risks between the exchange partners through efficient network relationships. Therefore, the degree of external risk sharing within the IFS is found high. The organizations within the MBFS are characterized by formal lenders-borrowers relationships. The degree of externalization of risks in these organizations is low compared to organizations in the IFS.

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[26] 'Islamic economics, finance and banking - theory and practice', Journal of Islamic Banking

Khan and Mirakhor , (1988). 'The financial system and monetary policy in an Islamic economy', Journal of Research in Islamic Economics.

As such, for those regional and multinational players operating in this part of the world, having access to the Islamic market is important from a competitive point of view and sometimes it is the only source of capital for some regional risks.

Interestingly, the Islamic market is growing and as it does, what it considers local and hence lower in risk, will include a larger part of the globe. Islamic financial institutions began as a geographic phenomenon; predominantly in the Gulf countries and Egypt. It now covers most of the Islamic world, from North Africa to Turkey, across Pakistan, all the way to Malaysia, Indonesia and Brunei. By the end of this century, Islam is predicted to become second only to Christianity in the USA and Europe, in terms of numbers of adherents. Considering the issues, one gets a feel of where the growth to this market might come from and how this market will perceive risk that it may now be considering as foreign.

3.5 MEASURES TAKEN FOR ISLAMISATION IN PAKISTAN:

Since its inception in 1948, Pakistan has taken numerous pragmatic steps for the elimination of interest from its economy for its ultimate goal_ transforming into an interest-free economy. A brief synopsis of the steps taken on the governmental level, throughout the history of Pakistan, is mentioned below.

- As per Article 2 of the Constitution, Islam is the State Religion of Pakistan. The Objectives Resolution was adopted by the first Constituent Assembly in 1949; it was the preamble of the 1956, 1962 and 1973 Constitutions. It provided that no law should be enacted that is repugnant to the injunctions of Islam. It was made substantive part of the Constitution in 1985.
- The Eighth Amendment of the 1973 Constitution, adopted by the National Assembly in 1985, also made room for creation of the Federal Shariat Court (FSC).
- Creation of the Council of Islamic Ideology (CII) in 1962. The report of the CII on Elimination of Interest (June, 1980) is genuinely considered to be **first major comprehensive work in the world** undertaken on Islamic banking and finance. [27]
- Practically, measures taken included the introduction of Zakat (June, 1980) and Ushr (tithe) (March, 1983) and elimination of interest from the operations of Specialized Financial Institutions (July, 1979 to July, 1985) and the commercial banks (January, 1981 to July, 1985).
- Commercial banks transformed their nomenclature during January 1981 to June 1985 based on the 12 modes. From July 1, 1985 all commercial banking in Pak Rupees was made interest-free. However, foreign currency deposits in Pakistan and on lending of foreign loans continued as before.

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[27] Khan, Abdul Jabbar, l986. 'Non-interest banking in Pakistan: a case study', paper presented to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.

Irshad, S.A., l964. Interest-Free Banking, Orient Press of Pakistan, Karachi

- However, the Federal Shariat Court (FSC) declared procedure adopted by banks un-Islamic in November 1991. The Government and some banks/DFIs preferred appeals to the **Shariat Appellate Bench (SAB)** of the Supreme Court of Pakistan.

- SAB delivered its judgment of December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001. However, SAB gave exemption for dealing with foreign parties on the basis of interest.

- The Government, in line with directives of SAB, constituted a high level Commission and a number of tasks forces and Committees to study the prospects of transformation of Pakistan's financial system for interest based to Shariah compliant and to chalk out the transformation plan. However, the Government came to the conclusion that transformation of the financial system as whole was not possible in short term due to a variety of factors/reasons. **Developing a viable and complete model of Islamic finance and putting it into practice was complex and difficult tasks and it would not be wise to under-estimate those difficulties and risks.** Therefore, it was decided to promote Islamic banking on parallel basis with conventional system.

- State Bank has issued the criteria for establishment of Islamic banks in private sector and subsidiaries and stand-alone branches by existing commercial banks to conduct Islamic banking in the country.

- A Musharaka-based Export Refinance Scheme has been designed by the State Bank in order to provide export finance to eligible exporters on the basis of Islamic modes of financing. Efforts are underway to develop Islamic money market instruments like **Ijarah, Sukuk** to facilitate the banks in respect of liquidity and SLR management.

- In addition to Meezan Bank as a full-fledged Islamic bank operating exclusively on Shariah compliant basis, three banks are operating seven IBBs (MCB, BoK, Bank Alfalah). Habib Bank Limited has also been given in principle approval for one stand-alone branch. State Bank has received applications for 24 IBBs to be opened in 2006.

- A full-fledged Islamic Banking Department has been created in the State Bank that would serve as a focal point for all matters relating to Islamic banking and finance in the country.

- A Shariah Board comprising two Shariah scholars and three experts in the areas of banking accounting and legal framework has been established in the State Bank of Pakistan to advise it one modes, procedures, laws and regulations for Islamic banking ensuring Shariah compliance and smooth operations of Islamic banks.

3.6 INTRODUCTION OF ZAKAT AND USHR:

According to the Ordinance, Zakat receipts are to be used for providing assistance to the needy, the indigent and the poor, particularly orphans and widows, the handicapped and the disabled, eligible to receive Zakat under the Shariah, for subsistence or rehabilitation.

According to the Zakat and Ushr Ordinance, 1980; Applied to Muslim citizens of Pakistan only; assets subject to Zakat were divided into two categories viz; subject to compulsory levy of Zakat and those at which payable voluntarily at discretion of the owner. @**2-1/2%** of the asset value on the Valuation Date; As against the rate of **2.5%** in the case of Zakat, the rate of Ushr, a form of Zakat levied on land produce, is 5% in the case of irrigated land**, 10%** for rain-fed land. The rate is 20% for the produce of forests and mines. The difference in the rates is in inverse proportion to the human labour and cost involved in the production of the various items. [28]

Today, over Rs. 20 billions of Zakat funds are lying idle for lack of an efficient distribution system. The program has come under a great deal of criticism for the uneven manner in which funds are disbursed. The Government enacted the **"Enforcement of Shariah Act, 1991"** under which the State is required to "take steps to ensure that the economic system of Pakistan is constructed on the basis of Islamic economic objectives, principles, and priorities".

3.7 PROTECTION GRANTED TO FOREIGN COMMITMENTS:

Section 18 of the Shariah Act, 1991 provides that notwithstanding any other provision of this Act or any decision of any Court, financial obligations incurred and contracts made between a National Institution (which includes the government, a statutory corporation, a company, or any person in Pakistan), and a Foreign Agency (which includes a foreign Government, a foreign financial institution, foreign capital market, including a bank and any lending agency and individuals, as well as suppliers of goods and services) shall continue to remain, and be valid, binding and operative.

3.8. PROSPECTS OF ISLAMIC BANKS AND FINANCE IN PAKISTAN

- Future depends upon innovative instruments to enhance liquidity, develop secondary money and capital markets and introduce public finance instruments.
- We need appropriate institutional arrangements; legal framework, taxation issues and human resource development need to be taken care of.

[28] Khan, M. S.,1986.'Islamic interest-free banking', I M F Staff Papers, March, 33(1):1-27.

1987 'Principles of monetary policy in an Islamic framework', paper presented to the International Institute of Islamic Economics, Islamabad, Pakistan, July.

Irshad, S.A., l964. Interest-Free Banking, Orient Press of Pakistan, Karachi

3.9 CHALLENGES FOR ISLAMIC BANKS AND FINANCE IN PAKISTAN

- Enforcement of contracts is not effective.
- Inefficient system for early recovery.
- Ineffective code of conduct for professionals.
- Development of Shariah compliant government securities.
- Research and development in the field of Islamic finance and economies.
- HR development and training to the banks staff on Islamic Banking and Finance.
- Education and public awareness about Islamic financial system.

CHAPTER 4

ANALYTICAL EVALUATION OF ISLAMIC BANKING AND FINANCE

4.1 LEGAL AND ECONOMIC ASPECTS OF ISLAMIC FINANCE

Islam, whose followers include almost one-quarter of the world's population, has made the faith into a guide governing all facets of life. Islamic Law, Shariah, is based on the Holy Quran "The Contemporary Message of Allah," The Most Merciful and the Most Beneficent, Sunnah "The preachings of the Prophet Muhammad", and Ijma or Umma "Consensus, the exercise of one's independent judgment based on scholarly interpretation of questions not covered by the first two sources"

Islamic Law governs only those who accept it as the revealed will of Allah; thus Islam tends to be a matter of personal philosophy, rather than geography (Crane). Western scholars, such as New York University's Anderson, have praised Islamic Law, who wrote:

" After thirteen centuries of accomplishment during which the Shariah has governed the lives of myriads of Muslims in successive generations, the great Law is still the object of careful study by scholars and jurists in the East and the West" (Anderson, ix).

According to Crane, there are almost no non-Muslims, especially Western businessmen, "with any knowledge of either the Shariah, i.e., Islamic Law, as it is now developing in the Middle East, or of Islamic economics which, at least in concept, is merely a branch of the Shariah."

Islamic banking and finance, based on the Islamic law of contracts, derives from the **Law of Tawheed**, i.e., "belief in the oneness of Allah, (and the teaching) that no one should claim for himself what is basically the creation of Allah or the product of another man's efforts and skills." Therefore, Islamic banking is based on- avoidance of fixed-rate interest, and on acceptance of deposits and investment funds on PLS (profit and loss sharing).

Islam condemns Riba (fixed interest), which "**reinforces the tendency for wealth to accumulate in the hands of a few, and thereby diminishes man's concern for his fellow men,"** guarantees gain without the risk of loss, and hampers investment and employment In even more explicit terms, riba is said "to impede the productive circulation of wealth, concentrate wealth in a class of economic drones, create an imbalance between production and consumption, increase the cost of production at the expense of consumers, impose rigidity in costs and a bias toward short run planning in investment, encourage unproductive speculation, and trigger credit imbalances and inflation" [29]

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[29] ("Islam and Financial Intermediation," pp. 110- 11). (Crane, p. 49)

Conversely, Islam teaches that absence of riba "provides a check on the exercise of private proprietorship, and tends to reduce exploitation of the labor force, while still permitting a free cooperative system" The need for social justice permeates Islamic teaching. For instance, expanded granting of consumer credit was recommended **by Dr. Muhammad Uzair**, Director of the International Center for Research in Islamic Economics (Saudi Arabia) at the 1976 Islamic Conference in Mecca; he suggested that interest-free consumer loans, premised on "living within one's means," should be small enough to be handled through an interest-free "residual fund" carried in the bank's current account. In other words, **Islamic banks not only to enable the borrowers to deal with personal or family emergencies and needs, but to assist them in raising their living standards, may provide consumer credit**.

The same orientation is reflected in another important concept, Zakat. In a western profit making enterprise, maximization of profit and minimization of loss represent the **"bottom line."** But Islamic economics is different. As Crane says:

"Western economists generally cannot conceive of any measure that extends beyond the material world, whereas Muslims generally cannot conceive of any measure that does not."[30]

Zakat, the giving of one's bounty to others, represents one of the pillars of Islam. When he accumulates wealth and earns mole than he needs, the Muslim becomes obligated to pay Zakat to purify himself from the sin of avarice. Zakat, as an instrument of the redistribution of wealth, and of the creation of a society based on mutual assistance, also is being implemented in Islamic banking institutions.

4.2 BENEFITS OF ISLAMIC ECONOMICS

Islamic economic desiderata may be summarized as follows:

- **Economic growth:** An Islamic economy penalizes the accumulation of idle wealth through Zakat, and encourages rapid reinvestment in order to increase production and productivity. Islamic finance is more efficient as it allocates investable funds on the basis of expected value productivity of projects rather than on the criterion of creditworthiness of those who own the projects, as is the case in debt-based finance. There is no guaranty that the most promising projects seeking finance will come from the most wealthy. As Schumpeter has shown the most innovative may be empty-handed. But debt-finance would not serve these. It would prefer those who, on the basis of other assets owned by them, would be able to pay back the sum borrowed, interest added, even when the project being finance failed to create additional wealth.

[30] Crane, p. 80).

Council of Islamic Ideology (CII), Pakistan, l983. 'Elimination of interest from the economy', in Ziauddin, Ahmed et al. (eds.).

- **Higher employment**: Investment is encouraged in projects, which produce wealth, rather than through relatively more passive fixed-income investments. The participative type of project is thought more likely to lead to higher employment, and to fewer negative social and economic effects.

- **Equal distribution of income and wealth**: Zakah is designed to promote more equal distribution of wealth. (Social justice, social cohesion, brotherhood, and the harmony aspects of Zakah have origins in Tawheed.)

- **Preserving equilibrium and modesty**: Wasteful consumption **(Israf)** is discouraged, while abstinence from waste and saving in the form of direct investment **(Iqtisad)** are encouraged.

- **Anti Money Laundering Measures:** The ease with which huge sums can be transferred across the globe with a single push of a button has facilitated international trade and settlements, but the capability itself has given nightmares to the managers of developing economies trying to compete in an increasingly market based competitive environment, as also for developed economies by facilitating money laundering and terrorism.Islamic banks, by their nature, are less likely to engage in money laundering and other illegal activities such as financing of terrorism than the conventional banks.[31] Their disclosure standards are stringent because they require the customers to divulge the origins of their funds in order to ensure that they are not derived from illegal means. Islamic financing modes are used to finance specific physical assets like machinery, inventory, and equipment.

- **Partner in Trade:** The role of Islamic banks is not limited to a passive financier concerned only with timely interest payments and loan recovery. Islamic bank is a partner in trade and has to concern itself with the nature of business and profitability position of its clients.

- **KYC:** A stringer **'Know Your Customer' (KYC)** policy is an inbuilt requirement for an Islamic bank. Before entering into a contract Islamic banks are expected to have:

    a) Knowledge of business of the client

    b) Knowledge of the individual or collective management and their bonafides

    c) An internal code of ethics in negation of a singular profit objective

    d) Awareness of the spirit and basis of governing laws and regulations.

- **Justice and fairness:** To all concerned, was the main feature of a model of financial intermediation whose core was profit-sharing. Interest was essentially unfair because our environment does not guarantee positive returns to business

[31] Abdallah, A., 1987. 'Islamic banking', Journal of Islamic Banking and Finance, January-March, 4(1): 31-56

enterprise financed with borrowed money capital. Current practice penalizes entrepreneurship by obliging it to return the principal even when part of it is lost due to circumstances beyond the entrepreneur's control. Justice requires that money capital seeking profits should share the risk attached to profit making. A just system of financial intermediation would contribute to a more equitable distribution of income and wealth.

- **Stability:** Islamic finance will foster greater stability as it synchronizes payment obligations of the entrepreneur with his or her revenues. This is possible only when the obligation to pay back the funds acquired from the financier and pay a profit is related to realization of profits in the project in which the funds are invested, as it is in the profit-sharing model. Contrary to this, in the debt-financing model the payment obligations of the entrepreneur are dated as well as fixed in amount. The same is the case with the financial intermediaries; their commitment to the depositors in time and saving accounts is to pay back the sum deposited with interest added. When a project fails and businessman defaults, the financial intermediary must also default, with ripple effects destabilizing the whole system. The debt-based financial system of capitalism is inherently prone to recurrent crises.

- **Eliminate the risk:** The linking of depositors' entitlements to the actual profitability of the projects in which their monies are invested through the services of the financial intermediary, the bank would almost eliminate the risk of runs on the bank insofar as the investment accounts are concerned. A report or rumor that the bank investments are not doing well will not prompt a rush of withdrawals from investment accounts as depositors could get only what is actually salvageable. Waiting till the situation improves would be a more rational option.

- **Less prone to inflation:** Last but not the least, Islamic finance will be less prone to inflation and less vulnerable to gambling like speculation, both of these being currently fueled by the presence of huge quantities of debt instruments in the market. Debt instruments function as money substitutes while equity-based financial instruments do not. And speculators find it much easier to manipulate debt instruments than those based on profit-sharing.

It is true that these advantages belong to a system whose core is profit- sharing. But even Murabaha (cost-plus or mark-up) financing keeps the system far less vulnerable to inflation and gambling like speculation than the conventional debt-based arrangements. *Murabaha* is firmly linked with exchange of real goods and services. It is a price, to be paid later. It is essentially different from money given as a loan, which may or may not be linked to production or exchange of real goods and services.[32] An Islamic system of finance in which profit-sharing and mark-up financing both exist side by side would still retain the advantages noted above.

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32 Al-Jarhi, Ma'bid Ali, l983. 'A monetary and financial structure for an interest- free economy, institutions, mechanism and policy', in Ziauddin, Ahmad et al. (eds.), Money and Banking in Islam, International Centre for Research in Islamic Economics, Jeddah, and Institute of Policy Studies, Islamabad.

4.3 WEAKNESSES OF ISLAMIC ECONOMICS

- **Concentration of bank assets:** One of the main weaknesses that is argued by many economists is about the concentration of bank assets on short-term trade credits rather than on long-term financing. This is undesirable, not only because it is inconsistent with the intentions of the new system, but also because the heavy concentration on a few assets might increase risks and destabilizes the asset portfolios. This draws attention to the difficulty experienced in both Iran and Pakistan in financing budget deficits under a non-interest system and underscored the urgent need to devise suitable interest-free instruments.

- **Fixed-return techniques**: In Islamic banking, 66 per cent of all investment transactions in the Islamic banks the world over, at present, are through 'Murabaha'. But, authorities on shariah had expressed their reservations about 'Murabaha' as well as 'Ijarah' (leasing). They are of the view that these modes of financing are second line fixed-return techniques which could, at best, be adapted as transitory measures, while the ideal mode of financing for an Islamic bank was the one aimed at profit and loss sharing, which could ultimately replace the present interest-based system.

  However, it is not so easy for the Islamic banks to switch over to the profit and loss sharing business; at present as such a move could threaten their profitability due to the unethical business practices characterizing the business activities in Pakistan, today.[33]It may be recalled that, in an appeal filed in 1992, the federal Government had expressed its apprehensions that financing on profit and loss sharing basis on a large scale, without adequate safeguards, could cause serious setbacks to the banks in case the entrepreneurs, borrowing from the banks, maintained false boos of accounts to conceal their true profits, thereby denying due share of profits to the banks.

- **Safe Playing**: In view of the position stated above, the Islamic banks, doing business in Pakistan, appeared to have no other option at present but to play safe and continue with the time-tested mode of financing like 'Murabaha' or 'Ijarah' etc (instead of jumping into the profit and loss sharing business), in order to ensure their own safety as well as the safety of their depositors. At the same time, it should be hoped that, with the passage of time, the business culture in Pakistan would improve and unethical business practices would gradually disappear as a result of automation, documentation of economy, accountability and a growing sense of responsibility among the representatives of trade and industry themselves. The Islamic banks in Pakistan such as the Meezan bank could then be able to gradually switch over to financing on profit and loss sharing basis, in a bid to replace the present interest-based system.

- **Inability to do financing on profit and loss sharing basis:** The conventional banking system had been accepted as an integral part of the world economy and the

[33] Council of Islamic Ideology (CII), Pakistan, l983. 'Elimination of interest from the economy', in Ziauddin, Ahmed et al. (eds.).

desired liberation from it seemed to be infested with difficulties'. As a matter of fact, Islamic banking could prosper and flourish only in an Islamic environment, characterised by high standard of business integrity and honesty, equity and justice and welfare considerations instead of the prevailing race for the minimization of profits. In the absence of such an environment, the Islamic banks were unable to do financing on profit and loss sharing basis, as already explained in the preceding paragraphs. In other matters, also, the Islamic banks found it difficult to take an initiative and they had to follow the conventional banks in order to survive in a market economy.

- **Interest payments:** Another Major problem with implementing Islamic banking is that most other Muslim countries which have introduced Islamic banking systems have found other ways to offer interest payments. Economic analysts in Pakistan fear an interest-free economy would make it hard for the country to attract much-needed foreign investment or to secure further loans from international lenders.

Some people also argue that Pakistan's banking history and the legacy of billions of rupees of bad debts goes against a full-scale transition.[34] There are no assurances that an Islamic banking relationship, in which the depositor and borrower are partners in a business relationship, would not be exploited, supporters of mainstream banking argue.If a borrower decides to declare **himself bankrupt**, then there is **no protection** for the depositor, even if the borrower has laundered his profits illegally.

4.4 ACCOUNTING ASPECTS OF ISLAMIC FINANCE

To some degree, Islamic banks have adopted U.S. type accounting principles. For example, the principles followed by **Kuwait Finance House (KFH)** are summarized as follows:

1. **Historical Cost**: Assets are valued at historical cost.
2. **Depreciation**: Freehold land is not depreciated. The cost of other fixed assets is written off in equal installments over expected useful lives. KFH estimates useful lives as follows [Annual Report, 2001]:

Depreciation	
Furniture and fixtures	3 years
Plant and equipment	3 years
Motor vehicles	3 years

[34] Aftab, M., 1986. 'Pakistan moves to Islamic banking', The Banker, June: 57-60.

3. **Foreign Currencies:** Foreign currency transactions, and translation of assets and liabilities denominated in foreign currency, are calculated at the prevailing rates of exchange; any foreign exchange gains and losses are included in income.

4. **Inventories**: Valued at cost or market, whichever is lower.

5. **Investments in Property**: Carried at cost, less provision for decline in value; profit from long-term construction contracts is recognized on the completed contract method.

6. **Investment Accounts** (Short-term and long-term liabilities to depositors): Investment accounts are generally categorized as follows:

   a. Savings accounts for a minimum of one year (short term)
   b. Limited period deposits
   c. Unlimited period deposits, valid for one year; they are normally automatically renewable for the same period. Savings and time account depositors may participate in the profit of the bank on pre- determined terms. (The investment account represents a separate accounting and legal entity and presents accounting problems bearing on income determination and distribution, and profit measurement.)

7. **Zakat Scheme**: Islamic banks do not pay income taxes, but are obliged to put Zakat funds aside for beneficiaries, including scientific and religious organizations and needy persons. (The Zakah rate is 2.5% on accumulated wealth exceeding that necessary for personal use or consumption. Zakat is levied on capital and earnings, proceeds from sale of property, livestock, crops, etc. Assets not held for resale are exempt.)

8. **Financial Statements and Auditor's Report**: Islamic banks may provide fairly comprehensive statements together with an auditor's report.

However, as one such study reveals :

”**After a careful study of several financial statements of Islamic banks we noticed that it is no uniformity of the financial statements in content, nor in technology, form, and kind of statement, i.e., especially affecting distribution of income to depositors, Zakah Account, Investment Account Reserves, etc**.”[35]

Statutory Reserves: In order to protect the banks and their depositors, Islamic banks transfer percentages of their net profit to statutory reserves, according to local laws and regulations and their statutes.

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[35] Aftab, M., 1986. 'Pakistan moves to Islamic banking', The Banker, June: 57-60.

Mohsin, M., l982. 'Profile of riba-free banking', in M. Ariff (ed.), above. Naqvi, S.N.H., l98l. Ethics and Economics: An Islamic Synthesis, The Islamic Foundation, Leicester.

9. **Going-Concern Principles:** Valuation practices seem controversial, and Western accounting measurement may be difficult to apply in the Mudarabah bank environment.

10. **Capitalization and Dividends**: Shareholders' equity is composed of share capital, all common, without preferred stock. The statutory reserve and general reserve dividends are recommended by the Board-of Directors.

11. **Disclosure:** Those Islamic banks, which are audited by public ac- countants, tend to disclose considerable information, but not enough. For instance, due to the negative posture toward interest income, alternative sources of revenue probably should be disclosed, but may not be.

Creation of an Islamic accounting model would have important implications for international accounting standards and the operations of U.S. based public accounting firms (Wells and Islam).

Customer trust is an important factor for the success and survival of any bank, but especially for an Islamic bank established on the basis of Shariah and Islamic socioeconomic principles, in which faith and trust are basic. Hence, a religious supervisory board is commonly found in Islamic banks. Moreover, the IFIB has published guidelines specifying that two independent auditors are to be associated with an Islamic bank .

Central banks, or other local authorities which grant operating licenses to Islamic banks, may influence operations to some extent. In Kuwait, the influence of the central bank is relatively slight, because the Islamic Bank's (KFH's) Articles of Association (statutes) and its special status have been approved by the Cabinet. In Saudi Arabia, the operations of Islamic banks are affected by the **Saudi Arabian Monetary Authority (SAMA**.). In most Islamic nations, but especially in Iran, Pakistan, and the Sudan, Islamic banking is influenced by national goals. [36]

So far, no worldwide deposit insurance system has been created for Islamic banks, nor are there generally accepted standards of reserve requirements. Dr. Gamal Attia, while recommending several measures for protecting depositors, says, "It is necessary to impose strict conditions by stipulating a minimum of capital for Islamic banks higher than the minimum for other banks;it is also necessary to be stricter in the ratio between capital and deposits in Islamic banks." Referring to a reserve requirement, he said, "It is proposed that the legal reserve for Islamic banks be 10% of profit instead of the usual 5% and the general reserve to be 20% of profit instead of the usual 10%

Note: The discussion followed sets out to thoroughly examine the framework for musharakah (equity participation) and other financial instruments of the Islamic financial institutions. IT is divided into eight sections. The first defines musharakah and give its

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[36] Mohsin, M., l982. 'Profile of riba-free banking', in M. Ariff (ed.), above. Naqvi, S.N.H., l98l. Ethics and Economics: An Islamic Synthesis, The Islamic Foundation, Leicester.

historical background, while in the second the different types of musharakah are identified. The third deals with the conditions of present day musharakah, and the fourth analyses equity financing and its channels of investment in an Islamic society. The fifth identifys the steps to be taken to transfer to an equity financing system, and the sixth examines the role of equity financing in mobilizing funds and stabilization of the system. The seventh section describes other financial instruments of Islamic banks. Additional subsections are included which examine ijara (leasing), murabaha (cost plus financing), qard al-hasanah (beneficence loans), bai muajjal (deferred payment sale), bai salam (purchase with deferred delivery) and tadamun (solidarity). Finally some conclusions are drawn.

CHAPTER 5
MUSHARAKAH FINANCING MODEL

INTRODUCTION

In the contemporary world there is always a dilemma for the entrepreneur who has a promising idea for a new venture. How is he to raise the capital necessary to launch the venture? Borrowing the money is probably out of question. If the normal interest rate is 6% but the venture has a 10% chance of failing within a year, the lender will probably charge interest at a rate of 16%. High interest, plus amortization, will impose heavy fixed costs on the venture from the outset and this will increase the danger of failure, and in turn the interest rate. Moreover, if the venture's prospects can not be predicted with reasonable confidence, it will be very difficult even to calculate an appropriate interest rate. The alternative must be for the entrepreneur to admit a partner to the business who is entitled to receive a portion of profits from the venture, if any, in exchange for contributing the necessary capital to it. The partner's compensation is determined automatically by the fortunes of the business. There is no need to compute an interest rate and there are no fixed costs of debt, the partner will receive his profits only if and as earned.

However, Islam aims at establishing a social order where all individuals are united by bonds of brotherhood and affection like members of one single family. This brotherhood is universal and not parochial. It is not bound by any geographical boundaries and encompasses the whole of mankind and not anyone family group, tribe or race.

The purpose of this chapter is to thoroughly examine the framework for musharakah (equity participation) and other financial instruments of the Islamic banks. The chapter is divided into eight sections.[37] The first will define musharakah and give its historical background while in the second the different types of musharakah will be identified. The third will deal with the conditions of present day musharakah and the fourth analyses equity financing and its channels of investment in an Islamic society. The fifth will identify the steps to be taken to transfer to an equity financing system and the sixth is concerned with the role of equity financing in mobilizing funds and stabilization of the system. The seventh section describes other financial instruments of Islamic banks. Additional subsections are included which examine ijara (leasing), murabaha (cost plus financing), qard al-hasanah (beneficence loans), bai muajjal (deferred payment sale), bai salam (purchase with deferred delivery) and tadamun (solidarity). Finally some conclusions are drawn.

The concept of brotherhood and equal treatment of all individuals in society and before the law is not meaningful unless accompanied by economic justice such that everyone gets his due for his contribution to society or to the social product and that there is no exploitation of one individual by another.

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[37] Halim, Abdul, l986. 'Sources and uses of funds: a study of Bank Islam Malaysia Berhad,' paper presented to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.
Hjarpe, Jan, l986. 'Mudaraba banking and taka-ful insurance: the question of "Islamic Banks", their significance and possible impact', in Jan Selmer, and Loong Hoe Tan,

The Prophet aptly warned:

"Beware of injustice for injustice will be equivalent to darkness on the Day of judgement" .

This warning against injustice and exploitation is designed to protect the rights of all individuals in a society (whether consumers or producers and distributors, and whether employers or employees) and to promote general welfare, the ultimate goal of Islam.

Of special significance here is the relationship between the employer and the employee which Islam places in a proper setting and specifies norms for the mutual treatment of both so as to establish justice between them. An employee is entitled to a "just" wage for his contribution to output and it is unlawful for the employer to exploit his employee.

5.1. DEFINITION OF MUSHARAKAH & ITS HISTORICAL BACKGROUND

Musharakah or shirkah can be defined as a form of partnership where two or more persons combine either their capital or labour together, to share the profits, enjoying similar rights and liabilities.

From the very inception of human society, the methods to meet day to day needs have been changing with the change of social, economic, scientific, cultural and political circumstances, especially habits, fashions and the standard of living. These methods regulate the commercial activities and vary from place to place and time to time. The Arab society at the time of the rise of Islam had very simple financing methods and forms of business peculiar to that society.

The advent of the Holy Prophet saw the practice of *musharakah* already prevailing over the commercial activities in Arabia. He not only ratified it, but also himself did business on the basis of *musharakah*.

After Hijra, the muhajireen and the ansar were declared by the Prophet to be brothers. Subsequently they joined as partners, in the form of musharakah, muzara and musaqat, in their trade and commerce. The nature of the transaction, in the different forms, is identical. The different nomenclature in arabic refers to diverse activities such as muzara in agriculture, musaqat in gardening and musharakah in trade. The musharakah of capital and labour is called mudarabah. These four forms were so developed that they became independent institutions and the jurists formed detailed rules about them. There is a consensus of opinion among the jurists of all schools- of thought (including Hanfia, Maleki, Shafei, Hanbali and Shia) that musharakah is a valid and legitimate contract in Islam. The jurists, however differ over its form, conditions and other details.

5.2. TYPES OF MUSHARAKAH

Originally musharakah or shirkah (Partnership) was of two types. namely,

(a) Shirkah al-milk (non-contractual partnership)
(b) Shirkah al-uqood (contractual partnership)

Shirkah al-milk (non-contractual) implies co-ownership and comes into existence when two or more persons happen to get joint-ownership of some asset without having entered into a formal partnership agreement; for example, two persons receiving an inheritance or a gift of land or property which mayor may not be divisible. The partners have to share the gift. or inherited property or its income, in accordance with their share in it until they decide to divide it. If the property is divisible and the partners still decide to stick together, the shirkah al-milk is termed ikhtiyariyyah (voluntary). However, if it is indivisible and they are constrained to stay together, the shirkah al-milk is characterised as jabriyyah (involuntary).

Shirkah al-uqood (contractual partnership) can, however, be considered a proper partnership because the parties concerned have willingly entered into a contractual agreement for joint investment and the sharing of profits and risks. The agreement need not necessarily be formal and written, it could be informal and oral. Just as in mudarabah, the profits can be shared in any equitably agreed proportion. Losses must, however, be shared in proportion to the capital contribution.[38]

Shirkah al-uqood has been divided in the fiqh books into four kinds: al-mufawadah (full authority and obligation); al-inan (restricted authority and obligation); al-abdan (labour, skill and management); and al-wujuh (goodwill, credit-worthiness and contracts).

In the case of mufawadah the partners are adults, equal in their capital contribution, their ability to undertake responsibility and their share of profits and losses. They have full authority to act on behalf of the others and are jointly and severally responsible for the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. Thus each partner can act as an agent (wakil) for the partnership business and stand as surety or guarantor (kafil) for the other partners.

Khan, on the other hand implies that all partners need not be adults or have an equal share in the capital.[39]They are not equally responsible for the management of the business. Accordingly their share in profits may be unequal, but this must be clearly

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[38] Salama, Abidin Ahmad, l986. 'Utilisation of financial instruments: a case study of Faisal Islamic Bank (Sudan)', paper submitted to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur

[39] Khan, M. Fahim, l983. 'Islamic banking as practised now in the world' in Ziauddin, Ahmad et al. (eds.).

specified in the partnership contract Their share in losses would of course be in accordance with their capital contributions. Thus in shirkah al-inan the partners act as agents but not as sureties for their colleagues.

Shirkah al-abdan is where the partt1ers contribute their skills and efforts to the management of the business without contributing to the capital.

In shirkah al-wujuh the partners use their goodwill, their credit-worthiness and their contacts for promoting their business without contributing to the capital.2 Both these forms for partt1ership, where the partners do not contribute any capital, would remain confined essentially to small-scale businesses only.

These are of course models. In practice, however, the partt1ers may contribute not only finance but also labour, management and skills, and credit and goodwill, although not necessarily equally.

5.3. TYPES OF MODERN MUSHARAKAH AND ITS CONDITIONS

The modern business concerns being run on the basis of musharakah (as defined above) are as under:

1. Partnership: It is regulated by:-
    (a). Partnership rules framed by the government,
    (b). Business practices prevailing in the business community.

2. Limited company. This type of musharakah is strictly controlled by the statutory rules framed by the government Its commercial activities are, however, influenced by the business practices (urf).

3. Co-operative societies. This musharakah is also governed by statutory rules. Its commercial activities are influenced by the practices prevailing in the business community.

The above modern musharakah principally resembles shirkah al-inan. The details are, however, considerably different due to change of urf and other factors including modem commercial techniques, economic conditions and legal requirements. Let us discuss briefly the conditions of musharakah, which are those of shirkah al-inan. Other types of musharakah mentioned by jurists are nearly obsolete nowadays.

Capital to be invested by the partners may be unequal. For the majority of the jurists the capital should be in the shape of currency and not in the shape of goods. The condition for capital to be in the form of currency only was imposed when it was difficult to refer to the goods in terms of currency. This was true in the days of barter systems when the jurists framed the rules, but now goods are generally referred or accounted for in terms of currency.[40] This condition should, therefore, be waived. In limited companies and co-operative societies the capital is invested in the form of equal units of currency called shares and the intended partners buy as many shares as they wish. This practice has universally been accepted as urf and is therefore according to Islamic principles.

a). **Management**

Musharakah is run and managed by the will and equal rights of participation of all the partners. Different aspects of musharakah business are as follows :

1. Every partner is an agent for the other, as all the partners benefit from the musharakah business. When a contract of musharakah is made the condition of agency is automatically presumed to be in existence in the contract. The actual possession of a partner over a property of the musharakah business is considered as possession of other partners in as much as if a partner purchases half portion of a specific good for himself and half portion thereof for the musharakah. When he takes possession of that specific good, this possession will be considered as possession of all the partners. If, however, a partner purchases some goods for himself only, it is exclusively for him and not for the musharakah business.

2. Every partner enjoys equal rights in all respects in the absence of any condition to the contrary.

3. Any condition regarding participation in and administration of the *musharakah* and variation in the share of profit on this ground is valid. The contract of *musharakah* is not invalid on grounds of a condition of non-participation in the *musharakah* business, but on the ground that a share in the profit exists.

4. Every partner has a right to participate actively in the affairs of *musharakah* if he wishes.

In all modern forms of *musharakah*, the partners have equal rights as mentioned above. In the limited companies and cooperative societies the shareholders delegate their powers (rights in respect of administration etc.) to some among them to be called directors or given any other appropriate title. In a partnership concern the partners, by a mutual agreement, distribute among themselves their responsibilities, duties and jobs, As mentioned above these practices are valid being *urf* of business community.

b). **Distribution of Profit**

The basis for entitlement to the profits of a musharakah is capital, active participation in the musharakah business and responsibility. Profits are to be distributed among the partners in business on the basis of proportions settled by them in advance. The share of

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[40] Kahf, Monzer, l982a. 'Saving and investment functions in a two-sector Islamic economy', in M. Ariff (ed.) ,

every party in profit must be determined as a proportion or percentage. No fixed amount can be settled for any party.

Limited companies and co-operative societies distribute their profit according to the capital of share-holders. If any share-holder participates actively in these modem musharakah he is paid for it and such payments are regarded as the expenditure of musharakah. This is modem urf and there is nothing un-Islamic in this urf.

c). **Liability of Loss**

The entire jurists are, unanimously, of the view that the loss shall be borne by the partners according to their capitals. In all forms of musharakah (i.e.limited companies, co-operative societies and partnership) the loss is borne on the basis of capital invested.

There can be little doubt. after the citations above, of the unanimity of the principle. The jurists have categorically laid down that a party, which has no capital, invested in an enterprise, does not have to share its loss. From the explanation of the jurists, it is clear that it is not possible, after investment of capital, to avoid the risk of loss in the enterprise. This is a direct consequence of the prohibition of interest in Islam and is of fundamental importance for our analysis. The jurists point out that this is because of the fact that loss means destruction of a part of the capital and hence, as it occurs, is a liability of the owner of capital alone.

However, according to modem commercial practices the loss does not cut down the respective capitals of the partners or share-holders, but remains as it is in the accounts books of the musharakah in order to be adjusted against the future profits. It is pertinent to note that while adjusting the loss against future profits the accounting procedure automatically works in a manner so as to bear on the capitals subsequently.

d). **Withdrawal of Members**

In the early days of Islam the musharakah were generally formed on a short-term basis, mostly of a joint venture type. It was, therefore, quite easy for a partner to withdraw from a musharakah. The withdrawal did not create many problems such as the taxation of capital expenditure, the continuous nature of business activities and goodwill. This is why the old jurists did not feel any need to impose restrictions on the withdrawal of a partner, but in the present complicated commercial practices, legal requirements and public control entangle a musharakah for a considerable period so deeply and firmly that no partner or shareholder can be absolved of his liability as such. So according to a modem urf the shareholder of a limited company cannot withdraw from it and receive back his capital invested therein. He can, however, sell his share to any person desirous of becoming a shareholder of that company. In a partnership business a partner can be permitted to withdraw and receive his capital back after fulfilling his liabilities as a partner according to terms and conditions settled between the partners.

e). <u>Limited Liability</u>

A distinguishing feature of modern musharakah (except the partnership) is the limited liability of their shareholders. They Cannot be held liable for more than the amount of capital they have invested. This requirement makes it necessary to regard the musharakah as an entity separate from the individuality of the shareholders. This common urf has given way to safe and stable musharakah resulting in big commercial organizations and flourishing business.

To sum up this section, the shirkah al-Inan, which implies unequal shares and is recognised by all schools, may tend to be the most popular. In this case, the profits are divided in accordance with a contractually agreed proportion, since the shariah admits an entitlement to profit arising from a partner's contribution to any of the business assets. However, the shariah makes it clear that losses are to be shared in proportion to the contribution made to capital. This is because losses, constitute an erosion in equity and must be charged to the capital.[41] If a loss has been incurred in one period, it must be offset against profits in the subsequent periods until the entire loss has been written off and the capital sum restored to its original level. However, until the total loss has been written off, any distribution of "profit" will be considered as an advance to the partners. Accordingly, it would be desirable to build reserves from profits to offset any losses that may be incurred in the future.

The real world situation may be a combination of *mudarabah* and *musharakah* where all partners contribute to the capital but not to the entrepreneurship and management. It this case profits need not be shared in accordance with capital contributions. They may be shared in any proportion agreed to by the partners, depending on their contribution to the success and profitability of the business.

f). <u>Equity Financing</u>

Equity financing in an Islamic economy may have to be for either an indefinite period, as it is in the case of the stock of the joint stock companies or shares in partnerships, or a definite (short, medium or long) period as it is in the case of borrowed capital (loans, advances, bonds and debentures). Since borrowed capital would also be on the basis of profit-and-loss sharing and could not be interest-based, it would be in the nature of temporary equity financing and would mature on the expiry of the specified period. Such financing would hence not carry the same connotation as it does in the

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[41] Halim, Abdul, l986. 'Sources and uses of funds: a study of Bank Islam Malaysia Berhad,' paper presented to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.

capitalist economies. It would, like equity capital but unlike qard al-hasanah, not enjoy any lien on the assets of the firm.

The inability to secure a lien on the assets of the business financed, possible in the case of interest-based lending, would make the financiers more careful in evaluating the prospects of the business and cautious in providing finance. Moreover, it would be difficult to find medium or long term financing in an Islamic economy without sharing the ownership and control of the business. Expansion of the business would hence be closely related to the distribution of ownership and control. Similarly it would not be possible for anyone to earn an income on savings without being willing to share in the risks of business. Thus ownership, fruits and risks of business would become more widely distributed in an Islamic economy than is possible under capitalism.

There are three types of borrowers who are looking for funds to satisfy their financing needs. These are (i) private sector investors looking for funds to finance their expanding business; (ii) private sector borrowers seeking funds to finance tl1eir consumption needs; and (iii) governments seeking funds to finance their budgetary deficits. Can the needs of all three categories of borrowers be satisfied within the framework of equity financing? It is only the subject of private sector equity finance which is discussed in this section.

g). Channels of Equity in an Islamic Society

Islamic banking is equity-oriented and the Islamic instruments of financing would ideally be based on profit and loss sharing. This would bring a fundamental change in the role of Islamic banks and would convert them from creditors to partners.

The channels that equity investment may take in an Islamic society are the same as elsewhere, namely, sole proprietorship, partnership (including both *mudarabah* and *musharakah*) and joint stock companies. Cooperation can also play an important role in an Islamic economy because of its harmony with the value system of Islam and the valuable contribution it can make to the realisation of its goals.

(i) Sole Proprietorship

Generally speaking, the entrepreneur depends essentially in this case on his own finance and management He may be able to supplement his financial resources by supplier's credits which played an important role in Muslim society in the past and tends to be a major source of short-term capital.

If the sole proprietor needs substantial extra resources on a temporary basis for a specific consignment or profitable opportunities, he may raise the necessary finance from individuals or firms or financial institutions on a profit-and-loss sharing basis, in which case his sole proprietorship will merge into the *mudarabah* form of organisation.[42] If his need for funds is of a permanent nature, he may consider the entry into his business of other partners and take advantage of the *mudarabah* or *musharakah* forms of partnership, depending on whether he needs merely finance or managerial ability as well to complement his own business talent.

What this implies is that an enterprising businessman in an Islamic society need not be constrained in his ambitions by his own finance. He can still expand his business by securing funds on a profit-and-loss-sharing basis. This should actually be better for him as well as the financier in term of justice; the entrepreneur does not have to pay a predetermined rate of return irrespective of the outcome of his business and the financier does not get a low return even when the business is paying high dividends. Since the ultimate outcome of business is uncertain, one or other of the two parties, entrepreneur or financier, suffers from injustice is an interest-based arrangement and Islam wishes to eliminate injustice.

To sum up the sole proprietorship form of business organisation, along with mudarabah financing, needs to be encouraged as it will help achieve the goals of Islam. It provides self-employment, and enables the entrepreneur to stay in his own town or village, thus helping reduce concentration of population in a few large urban centres.

(ii) Partnership

It is the relationship which exists between two or more persons carrying on a business in common with a view to profit.

The definition provides us with three requirements for a partnership in that there must be a business, that it must be trading (carrying on), and that it must have the capability of making a profit.

Where, at the beginning of a business, one partner provides, say £5,000 in, cash and the other provides the professional skill and expertise to make the venture work it will be a matter for them to decide how the rewards of the business are to be shared out. In the absence of any agreement no interest will be paid on capital, profits will be divided equally and, in the event of a dissolution, the second partner will be required to bear an equal share of any loss of capital, although he will not be entitled to share in the increase in value of capital unless it has been turned into partnership property.

The distinctive features of the partnership is the right of each of the partners to participate in running the firm and it is this right which gives rise to a number of obligations which partners have towards each other. If it is accepted that each partner participates then it is obviously important that there is a sound relationship between them.

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[42] l985. Toward a Just Monetary System, The Islamic Foundation, Leicester.

Partnership in an Islamic society may take one of two juristic forms, mudarabah or musharakah. The Islamic jurists have proposed other forms of partnership to provide credit and finance for Agricultural, manufacturing and trading purposes. These are:

(1) Consecutive Partnership

This instrument of financing is a real innovation on the part of the Islamic banks. The formula is used as a basis for the distribution of profits among depositors, who, in Islamic banks, hold a middle place between shareholders of equity on the one hand and depositors and or lenders on the other. Consecutive partnership formula, practised by all Islamic banks, considers depositors of one financial year as partners in the proceeds of that financial year, regardless of matching between the periods of projects in which their funds were used. Indeed, even some proceeds pending from previous years, for which accruals or provisions were made, are included in the proceeds of the year in question. On the other hand, some yields corresponding to the said financial year are excluded, if they are not yet due, and left to a future year.

Such an accounting system was necessary to reconcile the depositors' need to withdraw funds, regardless of the liquidation of investment in which their funds are used, with the continuity of the bank's investments which constantly flow in a mixed basket, and the need to make regular accounts every financial year, as an accounting unit for this basket.

(2) Agricultural Partnerships

Privately owned agricultural land could be exploited in one of the three ways: (a) directly by the owner, (b) indirectly by renting it (*ijara*), (c) through agricultural partnership.

The two main frameworks in traditional Islamic law for agricultural enterprise are (a) muzara' a (share cropping) and musaqat (water partnership or tree-sharing). Both these techniques typically afford a partnership between capital and labour.

(a) Sharecropping

Muzara' a (sharecropping or crop partnership) is a contract whereby the landlord puts his land at the farmer's disposal to farm and the farmer undertakes to give the owner an amount of the agricultural products. This framework is, of course, based on the generally accepted view that there should be a partnership between capital and labour.

(b) Tree-sharing

A contract is termed ***musaqat*** (water partnership or tree-sharing) when one person strikes a deal with another person calling for the latter to trim and water those fruit trees whose fruits are either one's own, or are at his disposal, in exchange for an amount of the fruits, as agreed upon. If a contract of *musaqat* or treesharing related to fruitless trees, like willows and sycophants, it is not valid. However, it would be valid in such trees as henna whose leaves are used or in those trees whose flowers are used.

(iii) A combination of sole proprietorship and partnership

In practice, business organisations would reflect a combination of sole proprietorship and mudarabah or a combination of musharakah and mudarabah. Not all savers can, or are interested in participating in the management of a business and may be just looking for opportunities to invest their surplus funds for short, medium or long-term periods. They could in this case make financing available to on-going businesses and share in the profits and losses in accordance with agreed ratios. [43]

(iv) Joint stock companies

These constitute along with financial institutions the most convenient form of investment available to a majority of savers, who have neither their own businesses to invest in nor the ability to evaluate running business or become sleeping partners. Corporate shares would be more attractive to them because of, the relative ease with which they can acquire them when they wish to invest, or to sell them when they need the liquidity. In the light of Islamic teachings it will however be necessary to reform joint stock companies to safeguard the interests of share holders and consumers, and also to reform stock exchanges to ensure that share prices reflect more or less the underlying economic conditions and do not fluctuate erratically in response to speculative forces.

(v) Cooperation

In addition to the above forms of business organisation, which are all profit-oriented, "cooperation", which is service- oriented, could make a rich contribution to the realisation of the goals of an Islamic economy. With the emphasis of Islam on brotherhood, "cooperation" in its various forms to solve the mutual problems of producers, businesses, consumers, savers, and investors should receive considerable emphasis in a Muslim society.

Cooperative societies could render a number of valuable services to members, including temporary financial accommodation when necessary through a mutual fund, the economies of bulk purchases and sales, maintenance facilities, advisory services, assistance or training for solving management and technical problems, and mutual insurance. Cooperation is a mutually beneficial relationship for all concerned, and everyone's participation is completely voluntary.

Informal cooperation between craftsmen and businesses is quite widespread in Muslim history. In all these forms of informal cooperation, businesses rendered services to each other without receiving any profit, commission or remuneration. These different forms

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[43] Choudhury, Masul Alam, l986. Contributions to Islamic Economic Theory: A Study in Social Economics, St Martin Press, New York

reflected not only Islamic brotherhood and mutual trust but also fulfilled the common needs of businessmen on a mutually cooperative basis.

Historical experience has shown that during the jahiliyah (pre-Islarnic) period, trade (over many territories) stretched over long distances and all financial resources were mobilised on the basis of either interest or mudarabah and musharakah. Islam, however, abolished the interest basis and organised the entire production and trade on the basis of mudarabah and musharakah. With the abolition of interest, economic activity in the Muslim world did not suffer any decline. In fact there was increased prosperity.

A combination of several economic and political factors, including the ability to mobilise adequate financial resources, were responsible for this prosperity. All these factors together provided a great boost to trade which flourished from Morocco and Spain in the west, to India and China in the east, Central Asia in the north, and Africa in the south. Therefore, the economic prosperity in the Muslim world had made possible a development of industrial skill which brought the artistic value of the products to an unequalled height.

Mudarabah and musharakah were the basic methods, by which financial resources were mobilised and combined with entrepreneurial and managerial skills for purposes of expanding long-distance trade and supporting crafts and manufacture. They fulfilled the needs of commerce and industry and enabled them to thrive to the optimum level given the prevailing technological environment.[44]

5.4 STEPS TO BE TAKEN TO TRANSFORM TO AN EQUITY FINANCING SYSTEM

It was mentioned earlier that to abolish interest implies that all businesses in Muslim countries, including industry and agriculture, currently operating on the basis of a mix of equity and interest-based loans, would have to become primarily equity-based.

This requires that all financial needs of a permanent nature, whether for fixed or working capital should normally be expected to come out of equity capital in an Islamic economy. This broader equity-capital base may be supported to the extent necessary by medium-and long-term mudarabah advances. Short-term loan financing, even though in a profit-and-loss sharing framework, may be resorted to only for bridge-financing or temporary shortage of liquidity resulting from seasonal peaks in business for which purpose it may not be desirable or feasible to have a permanent increase in equity.

A number of steps would need to be taken to bring about the transformation to an equity-based financing system in the gradual Islamisation of the economy of Muslim countries.

Firstly, projects should be selected for funding through partnerships primarily on the basis of their expected profitability rather than the creditworthiness or solvency of the

[44] Hjarpe, Jan, l986. 'Mudaraba banking and taka-ful insurance: the question of "Islamic Banks", their significance and possible impact', in Jan Selmer, and Loong Hoe Tan,

borrower. This factor, together with the predominance of equity markets and the absence of debt markets, has led Muslim scholars to conclude that, potentially, in an Islamic system, there would be : (a) a greater number and variety of investment projects that would be seeking financing; (b) a more cautious, selective, and perhaps more efficient project selection by the savers and investors; and (c) a greater involvement by the public in investment and entrepreneurial activities, particularly as private equity markets develop.

Secondly, to enable firms to increase their equity it may be necessary to "regularise" the existing stock of "black" money (arising from tax evasion), the major outlet for which currently is mainly capital outflows or conspicuous consumption. This move should help draw a substantial volume of such funds into the fold of investment without this move it may be difficult to increase equity because there may not be a sufficient volume of "white" money in the economy for this purpose. In the next chapter we will be discussing this issue in the context of the middle east stock markets.[45]

Thirdly, tax laws should be revised to treat interest payments in the same way as dividends and profits are now being treated, and taxes should be levied on gross profits before interest payments. In fact, it would be desirable to impose a higher rate of tax on the interest portion of the gross income than that applied to profits to accelerate the transformation to an 'equity-based financing structure.

Fourthly, the tax structure of Muslim countries should be streamlined to ensure that it does not discourage investment and channel even legally earned profits into "black" money. While Islam does allow the levying of taxes to a reasonable extent to meet all necessary and desirable state expenditures, it does not permit an unjust tax structure, which penalizes honesty and creates the un-Islamic tendency of evading taxes.

Finally, the formation of appropriate financial institutions and investment banks should be encouraged to make venture capital available to businesses and industries and thus enable them to undertake necessary investments. In the process they would also provide investment opportunities to savers who are either unable to find lucrative opportunities, for direct investment, or are unable to locate partners or mudaribs for profitable investment of their savings.

5.5. The Role of Equity Financing in Mobilising Funds and Stabilization of the System

Given Islam's emphasis on equity financing, there should re a greater urge to save for investment in one's own business. If there are profitable opportunities for investment which cannot re exploited by reliance merely on internal cash flows, access could be had for premises, equipment and supplies through leasing, murabaha or bai muajjal, and supplier's credits. Businesses desiring further expansion could also mobilise resources on

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45 Chapra, M. Umer, l982. 'Money and banking in an Islamic economy' in M Ariff (ed.), above.

____ l985. Toward a Just Monetary System, The Islamic Foundation, Leicester.

the basis of profit, mudarabah or musharakah. Market forces will take care of those who act in a self-defeating manner. Nevertheless, a state-regulated proper auditing system can be instituted to safeguard the interest of investors.

Joint stock companies should also play an important role in an Islamic economy. Their shares would re available to investors who are not active or do not wish to make their funds available to sole proprietors or partnerships. Corporate equities constitute a substantial proportion of total capital formation in capitalist societies.

In an Islamic economy, it is always possible for an individual investor to diversify and reduce his risk by making fM1ancial institutions and investment trusts a vehicle for his investment because such institutions diversify their own risk by properly regulating their exposure to different sectors of the economy as do individuals and firms. It must be clearly understood that the return on equity in an Islamic economy will not re equal to just "profit" but will rather re the sum of what constitutes "interest plus profit" in the capitalist economy and is called "return on capital". It will include the reward for saving and risk-taking, on the one hand, and entrepreneurship, management and innovation, on the other.

Hence the Islamic system should be able to ensure justice between the entrepreneur and the financier. No one would be assured of a predetermined rate of return. One must participate in the risk and share in the outcome of business. This may not necessarily change the total outcome. It would no doubt change the distribution of the total outcome in accordance with the Islamic norm of socio-economic justice. It would also eliminate the erratic and irrational fluctuation between the shares of the savers or financiers and the entrepreneurs. Hence situations where the savers suffer (if interest is low and profit is high) or the entrepreneurs suffer (if interest is high and profit is low or negative) would be eliminated and justice established between the two. The impact of this should be healthy on both savers and entrepreneurs.[46]

When it comes to the question of stability, it must be realized that the stability of any economic system may be evaluated either empirically or analytically. Empirically, the simulation of an econometric model of a given economy has been successfully tried to evaluate stability. The results of such investigations, however, lack the generality of analytical results. Furthermore, this approach cannot be employed in the present case since a full-fledged Islamic economic system does not as yet exist.

Analytical methods of examining stability have also been developed by economists and have provided important general results. Such methods have not yet been applied to study an Islamic economy and have in any case their own limitations. More importantly, stability is quite responsive to government action and regulations, hence a definitive analysis requires the specification of several institutional details.

All things considered, there appears to be room for offering some remarks on the stability of an equity-based Islamic economy. The profit in the equity-based system will be

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[46] Ahmad, Sheikh Mahmud, l952. Economics of Islam, Lahore.

____, n.d. 'Interest and Unemployment', Islamic Studies, Islamabad, VIII (l): 9-46 dependent on the profit-sharing ratio and the ultimate outcome of the business. The share of the entrepreneur or financier cannot fluctuate violently from month to month. Moreover the distribution of the total return on capital (profit plus interest) between the entrepreneur and the financier would be determined more equitably by economic considerations and not by speculative financial market forces. In case of dividends it can however, be reduced in bad times and, in extreme situations, even passed. So the burden of finance by shares is less. There is no doubt that in good times an increased dividend would be expected, but it is precisely in such times that the burden of higher dividend can be borne. This factor should tend to have the effect of substantially reducing business failures, and in turn dampening, rather than accentuating, economic instability. Minsky argues that when each firm finances its own cash flow and plans to invest its own retained profits, there is no problem of effective demand, the financial system is robust and investment has great inertia. When firms can raise outside finance direct from rentiers or through the banks, they are liable to instability. [47]Schemes of investment are planned that are viable only if the overall rate of investment continues to rise. A fragile debt structure is built up. When the acceleration in the rate of investment tapers off, some businesses find current receipts less than current obligations, and a financial collapse occurs. During a boom, equity holders experience capital gains and increase the ratio of expenditure to income; when the boom breaks, thriftiness increases. Thus, long-run average growth may occur in cycles.

Interest rate volatility has defeated all efforts to restore stability to exchange rates. In a fixed parity system it is impossible to keep the exchange rates pegged because of the movement of "hot" money to take advantage of interest rate differentials. The effort to keep the exchange rate pegged leads to a significant loss of central bank reserves and impairs confidence in the strength of the currency. In a floating exchange rate system, where the rate tries to find its own equilibrium level and fluctuate excessively from day to day in response to international interest rate movements bearing no relationship to underlying economic conditions, it becomes difficult to predict exchange rates. This renders long-term planning almost impossible. A country facing a recession is unable to keep its interest rates low because such a policy leads to an outflow of funds, depreciates the exchange rate of its currency, and raises the cost of living. To prevent an even deeper plunge in the value of its currency, the recession-ridden country is forced to maintain interest rates at a higher level than dictated by the need for recovery. This, in turn, slows down the recovery and undermines confidence in the government.

The elimination of interest and its replacement by profit-loss-sharing would not only change the level of uncertainty but also redistribute the consequences of uncertainty over all parties to a business. It would moreover, by removing the daily destabilizing influence of fluctuating interest rates, bring about a commitment of funds for a longer period and also introduce a discipline in investment decisions. In such an environment the strength or weakness of a currency would tend to depend on the underlying strength of the economy, particularly the rate of inflation, and exchange rates. Accompanied by the Islamic emphasis on internal stability in the value of money, exchange rates should prove to be more stable

[47] Salama, Abidin Ahmad, l986. 'Utilisation of financial instruments: a case study of Faisal Islamic Bank (Sudan)', paper submitted to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.

because all other factors influencing exchange rates, such as cyclical developments, structural imbalances and differences in growth rates, are of a long-run nature and influence expectations about long-term trends in exchange rates.

Moreover, in the Islamic system, there will also be a greater interdependence and a closer relationship between investment and deposit yields because banks can primarily accept investment deposits on the basis of profit-sharing and can provide funds to the-enterprises on the same basis. Due to the fact that the return to liabilities will be a direct function of the return to asset portfolios and also because assets are created in response to investment opportunities in the real sector, the return to financing is removed from the cost side and relegated to the profit side, thereby allowing the rate of return to financing to be determined by productivity in the real sector. It will be the real sector that determines the rate of return to the financial sector in the Islamic financial system rather than the other way around. For these reasons, Islamic banking tends to reduce the vulnerability of the capital importing country to fluctuations in the level of capital inflows and to a sharp slowdown of new investment due to uncertainty among investors.[48]

In the Islamic system, no such instability exists when a bank, rather than issuing fixed liabilities, issues shares to its depositors. In this case assets acquired by the banks are transparent to investors, they are no more or less than the deposits supporting them. If there is a decline in the value of the bank's assets then it will not be to the advantage of depositors to withdraw their money because their share would consequently decline. Also the welfare of a depositor does not depend on the actions of other depositors because each gets a share in the bank's value which is independent of whether some withdraw their shares while others do not. In fact there is a greater incentive to remain in the bank when it suffers a decline in the value of its assets because otherwise it will mean acceptance of a loss on initial deposit. whereas retaining shares in the bank will give hope" for a revaluation of the bank's assets in the future.Perhaps the greatest advantage of such a system is that it not only resolves the bank's problem of panic among its clients but it also does not require the provision of deposit insurance and other government interventions surrounding banking institutions.

5.6. Other Financial Instruments of Islamic Financing

The Islamic banks are engaged in developing various instruments of financing which not only conform to the Islamic tenets of equity and fairness but will also stand the test of day to day business, corporate needs of the modern world and the sophisticated tools of scientific analysis.[49] The Islamic banks have identified and developed a relatively broad range of business and banking contracts. These include:

a). Ijara (Leasing) Definition and its Advantages

[48] l982b. 'Fiscal and monetary policies in an Islamic economy', in M. Ariff (ed.),above

[49], l986. 'Islamic economics, finance and banking - theory and practice', Journal of Islamic Banking and Finance, 3(2):36-54.

Ijara means a lease contract as well as a hire contract. In the context of Islamic banking it is a lease contract under which the bank of financial institution leases equipment or a building to one of its clients against a fixed charge.

The primary advantage of ijara over the conventional forms of borrowing to finance equipment is that the ownership of the asset remains with the lessor. The financing is largely unrelated to the size of assets and the capital base of the lessee and depends principally on the ability of his cash flow to service payments of lease rentals.

Ijara is probably the most suitable means to raise investment funds especially for industries where rapid technological innovation is either underway or desired and for top class firms which are quickly expanding their business or small and medium enterprises and firms which have normally insufficient assets and capital base to meet normal collateral requirements of most other forms of long term financing. The basic security under the ijara arrangement is the "ownership of the equipment". The title of ownership to the equipment remains with the leasing company and in case of serious default the equipment is repossessed.

b). The Modern Concept of Ijara

Leasing is the modem technique that can be compared with the Islamic technique of ijara. Leasing is based on the same fundamental concept of ijara according to which one does not have to own an asset in order to enjoy the benefits of it. It is now being applied on a large scale to business activity. There are obvious examples of businesses which have benefited from their investment in fixed assets over the years. Some businesses have made substantial capital profits from the sale of assets or have been able to improve the look of their balance sheets by the revaluation of assets. In the main, the profitability of a business lies in the use to which the resources are put It is the use, not necessarily the ownership, which matters.[50] Once a business decision for example the investment appraisal, has been made on some new venture, the choice of purchasing or leasing is partly a matter of arithmetic, partly a question of the availability of capital.

A comparison between leasing and other similar forms of transactions, such as rental, will give a clearer picture. "Rent" as is shown by the rent a car business, is a contract according to which the objects are leased to individuals or a number of users for a much shorter period than their actual useful life.

In contract law, the "rental contract" specifies the lease and usage for an indefinite period. A typical example is IBM's computer sales system. This system was initiated by the company, which has an over-whelming world market share to promote sales in an attempt to outstrip its competitors, in the belief that it could control the progress of technological

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[50] Nienhaus, V., l983. 'Profitability of Islamic PLS banks competing with interest banks: problems and prospects', Journal of Research in Islamic Economics, l(l):37-47

innovation of computers. While the users of the equipment leased on a rental system are major enterprises and their usage is continuous, the rented equipment is usually used in a transient manner, whether the case is "rental" or "rent" the lessor is charged with the responsibility for maintenance. Especially, in the case of "rental" the lessor is also charged with the responsibility for coping with the products obsolescence, so that it may be termed a service-oriented business.

c). Economic Role of Ijara

Lease financing because of its special features can supplement the existing conventional forms of financing and further accelerate investment in the private sector.

There is a large requirement of balancing and modernization of the existing industry. As a supplementary source of term credit, lease financing through balancing and modernization of the existing industry, will improve capacity utilization, quality, production cost, profitability, internal generation of cash for future investment and international competitive capability to increase exports. [51]

Lease financing is most suited to the programmes of balancing, modernization and replacement. It would involve a small dosage of investment, which would carry relatively smaller investment risk but would result in a quick value added production. It would increase capacity utilization and thus contribute to the growth of the economy.

d). Murabaha (Cost Plus Financing)

Murabaha is generally defined as the sale of a commodity for the price at which the vendor has purchased it, with the addition of a stated profit known to both the vendor and the purchaser. It is a cost-plus-profit contract Islamic financial institutions aim to make use of murabaha in circumstances where they will purchase raw materials, goods or equipment etc. and sell them to a client at cost, plus a negotiated profit margin to be paid normally by installments. With murabaha, Islamic financial institutions are no longer to share profits or losses, but instead assume the capacity of a classic financial intermediary.

The legality of murabaha is not questioned by any of the schools of law. There are of course differences in the details. However, the use of murabaha as a credit vehicle by the Islamic financial institutions has been regarded with apprehension by some Muslim economists, for example M. Siddiqi, who contended that the simple fact that murabaha enables a buyer to finance his purchase with deferred payments, as against accepting a mark-up on the market prices of the commodity, means that the financier, in this case the Islamic bank, earns a predetermined profit Without bearing any risk.

This form of contract is widely used for import finance. So the bank sells a commodity to the client for a predetermined amount or rate of profit over and above the total costs. Usually, goods or commodities are provided to the order of the client according

[51] Nienhaus, V., l983. 'Profitability of Islamic PLS banks competing with interest banks: problems and prospects', Journal of Research in Islamic Economics, l(l):37-47

to definite specification, but, following the rules of the Shariah Supervisory Board (SSB) (which is established in each bank under the bank's articles of association in order to make sure that each bank's transactions confirm to Islamic shariah), the client is not obliged to accept the goods or commodities, even if they are provided according to the given specification.

e). Beneficence Loans (Qard al-Hasanah)

Qard al-hasanah means an interest-free loan, which is the only loan permitted by shariah principles. Funds are advanced without any profit or charge for humanitarian and welfare purposes. Repayments are made over a period agreed by both parties. A levy of a modest service charge on such a loan is permissible provided it is based on the actual cost of administering the loan.

One may wonder how lending could be a business proposition once interest is "abolished. It seems that the Islamic financial institutions are advised to make use of qard al-hasanah in the following circumstances:

(i) In the case of *musharakah* between the institution and the client, it often happens that not all of the institution's shares in the project can be earmarked for the right to participate in profits; otherwise no substantial share would be left to the other partner, namely the client. Therefore the institution's participation is split into two parts: one constitutes a share in the partnership capital and the other a share in the working capital provided through *qard al-hasanah*.

(ii) A *qard al-hasanah* can also be provided to a client of the institution who has cash-flow problems, either in order to protect the institution's investment, or, when the cliQ1t is reliable, to boost the institution's image and reputation at no great risk.

(iii) A third use of *qard al-hasanah* may occur when a client who has with the financial institution a blocked savings account which generates no interest, encounters an urgent need for short-term finance, making recourse to the *mudarabah* concept useless. The necessary funds can be provided to him by the institution through *qard al-hasanah*.[52] There are probably other circumstances where *qard al-hasanah* has its value for the lender; these circumstances will gradually develop with the day to day business of the Islamic financial institutions.

f). Deferred Payment Sale (Bai Muajjal)

This transaction allows the sale of a product on the basis of deferred payment in installments or in a lump-surn payment. The price of the product is agreed to between the buyer and the seller at the time of the sale and cannot include any charges for deferring payments.

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[52] Mirakhor, Abbas, 1986. 'Some theoretical aspects of an Islamic financial system', paper presented at a Conference on Islamic Banking sponsored by the Central Bank of the Islamic Republic of Iran, Tehran, 11-14 June

g). Purchase with Deferred Delivery (Bai Salam)

In this transaction the buyer pays the seller the full-negotiated price of a specific product, which the seller promises to deliver at a specified future date. This transaction is limited to products whose quality and quantity can be fully specified at the time the contract is made.

h). Tadamun or Takaful (Solidarity)

Takaful literally means "mutual guarantee". In the context it is the Islamic answer to the modem concept of insurance, which is one of the most important subjects among scholars. This type of contract represents Islamic insurance based on a collective sharing of risk by a group of individuals whose payments are akin to premiums invested by the Islamic banking institution in a mudarabah for the benefit of the group. After a certain period, the group may expect to stop making further payments while remaining insured. The purpose of this solidarity mudarabah may be life assurance and it may also be risk insurance covering a property. If the assured person dies before the end of his covered time, or an insured risk on the property materializes, then payment is made out of the account of the insured person; if there is not enough money in that account, the outstanding balance is covered by the money of the other participants inside the same pool.[53] This is what is meant here by solidarity; the participants in a solidarity mudarabah share the consequences of a mishap. In other words, the participants in a given solidarity mudarabah have the right to share the surplus profits generated by such a mudarabah but at the same time they are liable for contributing to amounts in addition to the premiums they have already disbursed, if their initial premiums paid in during a particular year are not sufficient to meet all the losses and risks incurred during that year.

5.7. CONCLUSIONS

In this chapter and the preceding one, we have argued that mudarabah and musharakah are the basic methods by which financial resources are mobilised and combined with entrepreneurial and managerial skills for purposes of expanding long-distance trade and supporting crafts and manufacture. They fulfill the needs of commerce and industry and enable them .to thrive to the optimum level given the prevailing resource environment. These financial instruments along with others mentioned in this chapter constitute an important feature of both trade and industry and provide a framework for investment in a modern Islamic economy.

To sum up, an Islamic financial system is essentially **an equity-based system** in which depositors are treated as if they were shareholders of the bank. Consequently, depositors are not guaranteed the nominal value, or a predetermined rate of return, on their deposits. If the bank makes profits then the shareholder (depositor) would be entitled to receive a certain proportion of these profits. On the other hand, if the bank incurs losses the depositor is expected to share in these as well, and receive a negative rate of return. Thus,

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[53] Hjarpe, Jan, l986. 'Mudaraba banking and taka-ful insurance: the question of "Islamic Banks", their significance and possible impact',

from the depositor's perspective an Islamic commercial bank is in many respects similar to a mutual fund or investment trust Furthermore, to remain consistent with religious strictures, the bank cannot charge interest in its lending operations, but has to use special modes of investment and financing that are also based on the concept of profit and loss sharing system.

No doubt unit trusts and investment trusts are different The value of shares in an investment trust is determined in the stock market directly. In the case of a unit trust (e.g. the United States mutual fund) the value is based on a weighted basket of the underlying shares which are traded in the market.

With Islamic deposits, it is not the market value, which matters, there is none, as they are not traded. Nor is it the underlying value of the assets, which the bank has invested in unless there are deposits. What is important is the profitability of the investment Values of shares do not always reflect profitability. Profit/earnings ratios can vary widely, and the market accepts this. Similarity with unit trusts relates to the uncertainty regarding both returns and the value of Islamic deposits.[54] In practice however value seldom varies, which is not the case with unit trusts where it is determined by the market. In general Islamic deposits are less risky than unit trust holdings. Income oriented unit trusts are most easily compared to the Islamic deposits and not those, which are growth oriented. In this regard there is much confusion in the Islamic literature on finance, always reflect profitability. Profit/earnings ratios can vary widely, and the market accepts this.

Similarity with unit trusts relates to the uncertainty regarding both returns and the value of Islamic deposits. In practice however value seldom varies, which is not the case with unit trusts where it is determined by the market. In general **Islamic deposits are less risky than unit trust holdings**. Income oriented unit trusts are most easily compared to the Islamic deposits and not those which are growth oriented. In this regard there is much confusion in the Islamic literature on finance.

[54] Hjarpe, Jan, l986. 'Mudaraba banking and taka-ful insurance: the question of "Islamic Banks", their significance and possible impact',

CHAPTER 6
ISLAMIC STOCK EXCHANGES

This PART examines the Kuala Lumpur Stock Exchange (KLSE) as a financial intermediary and identifies the main beneficiaries of this market. It then investigates whether Islam can bring an alternative to the current practices to create a healthy and conducive environment for trading. Finally, the author proposes the establishment of a small Islamic stock exchange (SISE) to cater for the needs of small-and medium-sized enterprise to enable them to raise funds for business expansion.

KUALA LUMPUR STOCK EXCHANGE

IN THE CONTEMPORARY corporate world, the stock exchange plays an important role as financial intermediary between those who have surplus funds, and those who need the money. The former are the investors while the latter are the entrepreneurs. Therefore, the stock exchange is playing the role of a middleman or intermediary between these two parties. The Kuala Lumpur Stock Exchange (KLSE) is an organized market, and the two parties have to pay transaction costs for the services provided.

This chapter intends to

1. Analyse the current practices at the KLSE as a financial intermediary and identify the main beneficiaries;

2. Investigate whether Islam can bring an alternative to the current practices to create a healthy and conducive environment to the stock exchange; and

6.1 KLSE STRUCTURE

The KLSE is divided into two boards, namely, the Main Board and the Second Board. For the former, the requirement for a company to be listed is a minimum of RM20 million while for the later it is between RM5-20 million.

We must question whether this division of two main boards serve the needs of small-and medium-sized enterprises (SMEs) with less than RM5 million, whose main objectives are to raise funds (through KLSE) to expand their businesses. As far as we can see, the mechanism prevailing at the stock exchange does not only help the rich get richer but also make corporations bigger, more powerful, and monopolizing the wealth of the nation. Such practices, if not rectified by the relevant government authorities will sooner or latter make the stock exchange more alien to the society rather than part of it.[55] This fact enhances the argument that we are indeed living in a world of unfairness and injustice: the world of the giant corporations where the "bigger fishes swallow the smaller ones."

6.2 INVESTORS NOMENCLATURE

In the KLSE, there are also two main players, namely, the genuine investors and the inside traders. For the former, the main reason for their involvement in the stock exchange is simply either to raise funds for business expansion or to make quick profits. Therefore, the investors have to work harder and study the macro-economic fundamentals as their starting point. They have to analyse the various factors that will affect their investment decisions at the second stage. These factors are unemployment rate, inflation, business cycle, rate of growth, interest rates, etc. Once a thorough assessment has been made (by themselves or by their investment consultants) on the macro-economic fundamental, the second stage starts: analysing the micro fundamentals of the chosen companies among which are, their growth rates and past records, dividends, sales turnover, profitability and other financial ratios.

For the latter (the inside traders), they are known to spread rum ours in the stock exchanges. This kind of people; usually do not work hard compared with their counterparts (the genuine investors). Their main objective is to make a fortune over a short period at the expense of others. They would release false information and cause panic to the whole stock exchange, and more specifically, to the genuine investors, to make them quickly sell off their shares. Moreover, we suspect that these rumors are usually started by some of the big corporations in the stock exchange to manipulate the market and force the genuine investors to go out of the stock market forever. Many investors think that the inside traders are a group of people who will be able to buy the shares at a bargain price at the expense of the investors. This is why large number of investors refuse to raise funds from the stock exchange (perhaps also for moral and ethical reasons) for business expansion while others feel that current stock exchanges are becoming more like casinos or gambling dens, and according to their beliefs and ethics, such practices are unlawful and should be avoided. Ironically, such a practise does not only prevail at KLSE but also in other stock exchanges (like the New York Stock Exchange) all over the world. It is indeed based on speculations and manipulations (internal and external factors) rather than economic and financial fundamentals.

The question should be asked: should we continue to have such unfair practices in the stock exchange where few are monopolizing the wealth of the nation at the expense of the others? Or is it the right time for the policymakers in the corporate sector to restructure the stock exchange by bringing changes and introducing new rules and regulations to safeguard the small investors and entrepreneurs. If such changes were introduced and enforced (by the relevant authorities) they will undoubtedly create a healthy environment for

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[55] Halim, Abdul, l986. 'Sources and uses of funds: a study of Bank Islam Malaysia Berhad,' paper presented to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.

the whole financial market to exist. For the small investors, it will bring new hope and they will again be keen to be active players in the stock exchange either in buying or selling shares or by raising funds for business expansion.

6.3 AN ISLAMIC ALTERNATIVE

Islam as a way of life can bring an alternative and create a healthy environment to the stock exchange. The most fundamental teaching that Islam advocates in any financial transactions is "you should not do harm to others while others should not do harm to you."

At the macro level, this dynamic concept has its own grass-root Islamic foundation. It is based on ethical and moral values rather than materialism. It is focused on the role of man in the society as vicegerents (khilafah) of God (the main Creator and the real owner of wealth and natural resources of the universe) on earth. God has given man the responsibility to test him; the life we are in is indeed a test by God to mankind. Everything in life is planned and well monitored by the Creator, and man will be a accountable for his deeds and actions he has made in this life.[56] According to Chapra, God-given resources are indeed a trust and it should achieve the following objectives:

a. The resources are for the benefit of all, not just a few. They must be utilized equitably for the well-being of all.
b. Everyone must acquire resources rightfully and in accordance to the Quran and the Sunnah.
c. No one is authorized to destroy or waste the resources that God has given. To do so is equated by the Quran to the spreading of fasad (mischief and corruption) which God abhors.

If man fully understands the real message of Islam in life, he will live peacefully and in harmony with others based on the universal brotherhood.

Prophet Mohammad (May the peace and blessing of God be on him) said: "All human beings are dependents of God and the most beloved of them before Him are those who are best to His dependents."

He should be honest in dealing with others (realizing that God is monitoring him and there will be accountability afterwards) especially in any financial transaction. His main mission in life is hard work, responsibility, time management and sharing and caring for others. This is why Islam has given importance to the concept of universal brotherhood

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[56] Kahf, Monzer, l982a. 'Saving and investment functions in a two-sector Islamic economy', in M. Ariff (ed.) , above.

____ l982b. 'Fiscal and monetary policies in an Islamic economy', in M. Ariff (ed.),above.

which implies unity, co-operation and co-ordination rather than hatred, selfishness and greed which is prevailing in the conventional corporate world.

6.4 ISLAM: PRAGMATIC APPROACH

Islam encourages people to compete with each other in every aspect of life-in business and commerce, education and research and development--to help develop a solid and healthy society. Competitions raise efficiency and help promote human well-being, the overall objective of Islam. A society of trust, moral and ethical values. Undoubtedly, for investors, an improvement in the quality of production means that they will have a market for their product not only for the local but also foreign market to sell their products. Ultimately, the consumers (who are the main target) will benefit, so does the society as a whole. Therefore, competition will create a healthy environment and encourage the investors and entrepreneurs to work harder to have a market for their products.

This is why Islam is in favour of competition and against monopoly. The latter can bring harm to mankind and to the society as a whole. The resources will be wasted and he used unproductively and ultimately it will be monopolized and controlled by a few hands at the expense of others. Monopoly usually means selfishness, greediness, and oversized institutions.[57] This is why Islam advocates the concepts of "small is beautiful." If the small business is well managed, closely monitored and followed up, it can bring benefit to the society. Once these entrepreneurs are motivated through partnership financing they will work harder and improve their standard of living. They have a mission in life, the first and foremost, being to seek the pleasure of the Creator (who has given them the opportunities and the responsibilities) and to bring happiness not only to their families but also to other people and prosperity to the whole society. These investors (or entrepreneurs) are keen to be bigger and their main objectives are maximization of social benefit rather than maximization of the profit.

In Islam, savers and investors are considered as one body. Once a viable project is submitted to them (for financing) by an Islamic investment company (IIC), who will identify and select the projects based on economic and financial merits, the savers will automatically become the investors of those projects. This dynamic formula explains why Islam encourages us to go for partnership financing and venture capital. It is a challenge, and life without it is indeed meaningless. Muslims should face the challenge to survive in the new economic order set in a world of injustice, exploitations, and hatred between those that have and those that have not. Therefore, Islam has advocated planning for long-term financing for the development of human beings rather than short-term gains to please only some of the rich.

Such a long-term mission will require the need to establish an Islamic consultancy house (ICH) to cater for the needs of the development of human resources. The strategy of

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[57] Karsten, I., 1982. 'Islam and financial intermediation', IMF Staff Papers, March, 29(1):108-42.

the ICH relates to firstly, identification of the interrelated functions that should be performed in a certain sequential order for an effective and efficient promotional role; secondly, a mechanism for making effective decisions; and thirdly, the institutional machinery required to perform the various functions identified.

The ICH identifies the interrelated functions essential for its promotional role as follows:

a. Identification and selection of the project;
b. Preparation of the preliminary feasibility study;
c. Identification of entrepreneurs to undertake these projects;
d. Provision of training to potential entrepreneurs;
e. Preparation of detailed project reports;
f. Provision of technical and financial assistance for projects ready for implementation;
g. Monitoring and following up of projects;
h. Managerial and technical assistance for operating enterprises with problems;
j. Technical appraisal of projects requiring future financial assistance.

Once a viable and feasible project has been identified by a competent Islamic practitioner (or the ICH), based on economic and financial merits, it can be sold directly to the savers (who will be automatically investors) without any intermediary. A profitable project with a high rate of return will automatically find its market in the corporate sector (through the computer networks and information technology) without any financial intermediary.

From the above analysis, one can say that in Islamic economics, the financial intermediation will have a limited role to play in the society. Through financial intermediary, transaction costs will ultimately be paid by the society and the cost of capital will be expensive for many small entrepreneurs who want to start their venture capital. The current economic and financial crisis in the Western world have undoubtedly demonstrated that in the age of recession many small entrepreneurs cannot survive and they have to close down their workshops and factories. Such persistent economic and financial problems will have an adverse affect on the society as a whole. The main causes for such a situation are transaction costs and interest rates.[58] These people in the corporate world cannot grow simply because they cannot provide the collateral to the financial intermediaries (like the banks and other financial institutions).

6.5 PROPOSED ESTABLISHMENT OF A SMALL ISLAMIC STOCK EXCHANGE

From the above analyses, we are of the opinion that the policymakers in the government as well as corporate sector should study the proposal of establishing a small Islamic stock exchange (SISE) to cater for the needs of those small companies with smaller amounts of market capitalization requirement. Such a proposal is in line with the leadership Vision 2020 to promote the SMEs and make them more competitive and efficient. This proposal of establishing a SISE goes in line with Islamic principle where monopoly is

[58] Khan, W.M., l985. Towards an Interest-Free Islamic Economic System, The Islamic Foundation, Leicester

prohibited and competition from all parties are encouraged. It is also important for the relevant authorities to set up a Securities Exchange Commission (SEC) to regulate the market so that a healthy environment will be created so that the "bigger fishes will not swallow the smaller ones." Therefore, the government should consider the following steps.

First, It should impose very strict rules and regulations concerning speculation generated by rumours. Those who buy shares, must retain it at least for six months before they can sell them, and if they do sell those shares before the due time, higher tax or levy would be imposed on them. This will gradually reduce the role of rumours in the stock exchange. Recently, it was revealed that a few people were caught for this act in the Union Paper Holding short-selling scandal. According to Islamic values a person is not allowed to sell something which he does not possess. It is indeed unlawful and unethical to do such a thing.

And second, to reduce the role of the stock exchange as the financial intermediary between the investors and the entrepreneurs. For an entrepreneur to mobilize funds, computer networking and information technology can bring the two parties together without any intermediary. The new formula will be partnership financing between the investors on the one hand, and the entrepreneurs on the other. The transaction costs will be removed and the profit and loss sharing will be introduced as an alternative. We cannot deny that partnership financing will bring stability not only to the financial sector but to the whole economy.[59] This new formula of business enterprise known as partnership will forgo the role of the stock exchange as a financial intermediary, and can benefit not only the new parties but also the whole nation.

6.6LONDON STOCK EXCHANGE

The London Stock Exchange indicator (FTSE, known as Footsie) has posted an Islamic list of share prices for the growing number of people anxious to make halal investments.

Footsie (FTSE, short for Financial Times - Stock Exchange) is composed of the 100 top shares, and is the top measure of the London Stock Exhange, the biggest bourse in Europe.

The Islamic Footsies consist of a principal indicator with four regional indicators - Americas, Europe, Pacific and East Africa.The Islamic investment market is worth between $100 and 150 billion, and is growing rapidly at between 12 and 15 percent a year, according to Financial Times.

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[59] Mannan, M.A., l970. Islamic Economics, Lahore.

Mastura, Michael O., l988. 'Islamic banking: the Philippine experience', in M. Ariff (ed.), above.

The International Investor, a Kuwaiti firm specializing in Islamic investments is linked up with Footsie International, a subsidiary of the Financial Times and the London Stock Exchange, to start a system for quoting the Islamic prices on the Stock Exchange, which would give the shares better exposure. "Now it is being taken in the Footsie family, Footsie International being one of the world major indexes providers, it will increase (Islamic) exposure." (Financial Times)

It is said that the origins of the growth of this market "began not from a growing awareness of Islam but because of the tremendous wealth amassed by the Arabs during the past 20 years, coupled with the fact that usury is a serious thing in Islam."

Firms operating in such fields as alcoholic drinks, banks (because usury is banned by Islamic law), tobacco, gambling, insurance or any form of raising or selling pigs and pork, are excluded. The indices also exclude companies whose indebtedness exceeds a third or more of their capital, but permit investment in 24 currencies in 31 sectors.

Footsie International calculates the indices while The International Investor provides the expertise for identifying and evaluating the companies. A committee of four experts from an Islamic bank and Islamic judges is tasked with supervising the whole.

The Financial Times reported recently that the Islamic market was attracting more and more non-Islamic investors. The US Citigroup's Global Islamic Finance Group made $5.9 million profit last year while the British group HSBC set up an Islamic financial department. [60]For its part Barclays announced in October that it was launching a $30 million Islamic mutual fund.

The United States represents more than half of the main index, followed by the United Kingdom, France, Germany and Japan, which together account for a third. Main sectors covered by the 1,000 firms on the list are computers, pharmaceuticals and telecommunications, followed by autos, retailing, electronic equipment, media, chemicals and agro-food.

[60] Homoud, S.H., 1985. Islamic Banking, Arabian Information, London. Huq, Azizul, l986. 'Utilization of financial investments: a case study of Bangladesh', paper submitted to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur

CHAPTER 7

STOCK EXCHANGES IN PAKISTAN:

7.1 KSE

The stock exchanges in Pakistan have witnessed a substantial improvement since 1999-2000. With the spectacular performance of the KSE 100 index, which crossed 12000 points in 2007, (doubling the April 2004 level 5600 & quadrupling the January 2003 level) and market capitalization increasing from Rs 555 billion ($ 9.5 billion) in January 2003 to Rs 1436.0 billion ($ 25.0 billion) in April 2004, (an increase of 159 percent)and today it reached around Rs2.909 trillion.. The fiscal year 2005-06 has been a record year for the stock market in Pakistan, with un-precedent growth in market activity. Pakistan has experienced substantial economic changes since 2001-02, supported by strong sectoral growth. The stock exchange has shown foresight in whole-heartedly accepting and successfully implementing reforms as a result of which the Pakistani market was ranked as one of the best performing markets in the world. The KSE is implementing further measures to increase the retail investor base in the country.

The land-mark performance of the stock market during the current fiscal year can be attributed to a number of positive factors including; a continuation of pro-growth macro-economic policies; a stable macroeconomic environment; strong economic growth; stable exchange rate; a positive privatization process through the stock exchanges; a visible improvement in the Pakistan-India relationship; appropriate reforms initiated by the Securities and Exchange Commission of Pakistan (SEC); the availability of adequate liquidity in the market; good operating and financial results from the majority of blue chip companies and the enhancement of investor confidence, etc. This exceptional performance of the stock exchanges was also supported by the growth in rupee liquidity and the consequent availability of cheap credit to the private sector. In addition, the last four years have witnessed a recovery in the economy, which has helped improve corporate profitability and investor confidence. These factors have continued to drive the equity market in the current fiscal year as well.

Over the past few years, the Securities & Exchange Commission of Pakistan (SECP) has taken measures to restore confidence of both foreign and domestic investors by endeavoring to ensure that the market functions in a smooth and transparent manner. Its regulatory mechanisms are aimed at minimizing the elements of systemic risk on the one hand and promoting institutional strengthening/capacity building of various segments of the stock exchanges on the other. The SEC has actively pursued a stock market reform program geared towards the development of a modern and efficient corporate sector and stock market, based on sound regulatory principles that provide the impetus for high economic growth

According to a research out of the 15 leading stock markets in the world, the KSE share index increased by 61 percent in terms of US dollar during July-April 2005-06, surpassed only by India. The other 13 leading world stock markets recorded growth ranging from 7.0 percent (China) to 48 percent (Thailand). It is pertinent to mention here that unlike the previous year, all the leading stock markets of the world posted positive growth in the current fiscal year, which may be an encouraging indication of the world economic recovery. The SEC has introduced a number of significant reforms in the field of risk management. It has already constituted an expert committee comprising national and international market experts with the objective of formulating a comprehensive plan for the demutualization and integration of the stock exchanges. The recommendations of the committee on the de-modularization of the stock exchanges will be implemented by the end of the year as part of an ongoing stock market reform process. The end of the current fiscal year will also phase out carryover transactions (COT). For the development of cross border scrip listing the SEC consulted with SAARC corporate regulators and a memorandum of understanding has already been signed with Sri Lanka's corporate watchdog. A number of other structural reforms are also underway in the KSE and other stock exchanges which include: the introduction of trading in odd-lots; the development of an I.T. infrastructure for a backup system and the upgrading/expansion of the existing I.T. systems; the strengthening of the market monitoring and surveillance wing; the commencement of internet trading; the introduction of an over the counter (OTC) market; index trading; margin trading rules; and cross border listing. A future reforms agenda will also include a code of corporate governance for unlisted public companies and statutory corporations, an enhancement of monitoring and surveillance to prevent market abuse, and a corporate social responsibility (CSR) sector. The SEC has addressed numerous distortions in the stock exchanges and the corporate sector with a view to evolving a fair, transparent and efficient system that engenders investor confidence. At the same time, the SEC has ensured stringent enforcement to curb market abuses, particularly, in the securities market. A number of new products are also being envisaged which include the introduction of index and option trading. To cater to the expected increase in trading activities, especially through internet trading, the up-gradation and provision of backup trading and clearing systems is also in process. During the outgoing year, the KSE has further strengthened its international relations and continued to play an active role through the platform of the Federation of the Euro-Asian Stock Exchanges (FEAS) and the South Asian Federation of Exchanges (SAFE)[61].

[61] Khan, Abdul Jabbar, l986. 'Non-interest banking in Pakistan: a case study', paper presented to the Seminar on Developing a System of Islamic Financial Instruments, organized by the Ministry of Finance Malaysia and the Islamic Development Bank, Kuala Lumpur.

Table- 2:Performance of Global Stock Markets during July-April 2003-04

Country	Closing Index in Respective Currencies		% Change in USD
	April 2004	June 2003	
Pakistan	5,430	3,402	61
India	5,655	3,607	64
Indonesia	783	506	46
Thailand	648	462	48
South Korea	863	670	31
Hong Kong	11,943	9,577	25
Malaysia	838	692	21
Japan	11,762	9,083	41
Singapore	1,842	1,448	32
Sri Lanka	1,212	1,049	14
China	1,596	1,486	7
Philippines	1,555	1,223	22
Australia	3,408	2,999	22
US	1,107	975	14
UK	4,490	4,031	20

Source: Global Securities Pakistan Limited.

7.2 SECTORAL PERFORMANCE

During the first nine months of the outgoing fiscal year, the KSE share index and aggregate market capitalization of 12 different sector's have increased by 50.1 percent and 80.3 percent respectively, as against their increase of 53.4 percent and 44.7 percent in the same period last year.. All the 12 major trading groups on the KSE (cotton and other textiles, pharmaceuticals & chemicals, engineering, auto & allied, cables and electric goods, sugar and allied, paper and board, cement, fuel and energy, transport and communication, banks and other financial institutions, and miscellaneous) witnessed record growth in their share indices, ranging from 15.7 percent (sugar & allied) to 65.2 percent (cement).

Cotton and Other Textiles: In this group, there are three sub-groups: (a) textile spinning, (b) textile weaving & composite, and (c) other textiles. There were 229 companies listed with the KSE under this group in December 2006. The share index of cotton and other textiles recorded a growth of 37.4 percent during the first nine months of the current fiscal year as compared to a growth of 5.0 percent in the same period last year.

Chemicals & Pharmaceuticals: A total of 38 companies were listed with the KSE under this group at the end of December 2006. During the first nine months of the current fiscal year, its share index increased by a record 54.3 percent as compared to an increase of 27.0 percent in the comparable period of last year.

Auto and Allied: A total of 25 companies were listed with the KSE under this group at the end of December 2003. Its share index increased by 50.1 percent, while its market capitalization increased by 42.8 percent.

Sugar and Allied: Under this group, a total of 38 companies were listed with the KSE with a market capitalization of Rs 8.6 billion. The sugar and allied group is a minor player in the stock market although it has a weight of 8.6 percent in the production index of major industries. During the first three quarters of the current fiscal year, the share index of sugar and allied posted a growth of 15.7 percent as compared to a rise of 24.9 percent in the comparable period last year.

Cement: At the end of 2003, there were 22 cement companies listed with the KSE. The cement industry was one of the best performing sectors in the stock market. During July-March 2003-04 its share index grew by 65.2 percent, which was the highest among the 12 trading groups.

Fuel & Energy: A total of 25 companies were listed with the KSE. It is the most dominant group in the stock market. While its share index grew by 24.5 percent during the first nine months of the current fiscal year. Swelling fuel and energy sector is one of the major market players in the current year along with transport and communication, banking and finance and cement. The government has identified the energy sector as an engine of growth along with 3 other sectors, (agriculture, small and medium enterprises and information technology) and its unprecedented growth is expected to further promote investment activities in the country.

Transport & Communication: At the end of 2006, there were 15 companies of this group listed with the KSE. Its share index and market capitalization increased by 37.2 percent and 47.9 percent as compared to their rises of 58.5 percent and 43.5 percent in the same period last year. Its market capitalization constituted 13.5 percent of the aggregate market capitalization (AMC) making it a major player on the KSE. The combined market capitalization of fuel and energy, and transport & communication constitutes 51.1 percent of the AMC as compared to their share of 44.8 percent on the corresponding date of last year.

Banks & Other Financial Institutions: In December 2006, a total of 184 companies were listed with the KSE. There are 4 sub groups in this group: banks & investment companies, modarabas, leasing companies, and insurance. During the current fiscal year, the share index and market capitalization of this group has increased by 55.1 percent and 85.8 percent respectively.

Miscellaneous: The miscellaneous group includes five sub-groups: jute, food & allied, glass & ceramics, vanaspati & allied, and others. In December 2002, a total of 98 companies were listed with the KSE, which came down to 92 companies at end December 2006. Its share index and market capitalization posted growth of 33.5 percent and 37.6 percent respectively in the first nine months of the current fiscal year, as compared to their growth of 23.1 percent and 16.9 percent respectively, in the same period last year.

Sectoral Companies listed on Stock Exchange

Sector	Listed Companies	Market Capitalization(Rs bn)
Textile Spinning	143	11.6
Textile Composite	56	10.1
Modaraba Companies	46	3.4
Investment Companies	40	20.8
Mutual Funds	39	3.0
Insurance Companies	39	9.5
Sugar & Allied	38	4.2
Chemicals & Pharmaceuticals	38	49.9
Leasing Companies	32	3.2
Miscellaneous	29	43.5
Fuel & Energy	27	81.7
Textile Weaving	25	1.6
Auto & Allied Engineering	25	7.7
Synthetic & Rayon	25	14.7
Food & Allied	22	22.3
Cement	21	10.1
Vanaspati & Allied	19	0.3
Cables & Electrical	18	2.2
Engineering	16	1.6
Paper & Board	15	4.5
Glass & Ceramics	10	0.8
Transport & Communications	8	73.0
Woolen & Textile	7	0.3
Jute	7	0.3
Leather & Tanneries	6	1.0
Tobacco	6	5.0
Constructions	4	0.1
Total:	**761**	**390.0**

The KSE is primarily influenced by some big blue chip companies including; Hub Power, PTCL, Pakistan State Oil etc. During the first three quarters of the current fiscal year, the combined turnover of shares of ten big companies (OGDC, Hub Power, PTCL, Sui-Northern Gas, FF Bin Qasim, D.G. Khan Cement, Dewan Salman, PIAC, Fauji Cement and Lucy Cement) was 12.44 billion, which constituted 19.1 percent of the total turnover of the KSE.

7.3 MAJOR INSTITUTIONAL DEVELOPMENTS:

For rapid development of the stock market, Government of Pakistan has taken a number of policy decisions, which will go a long way in revamping the overall structure of the stock market and seek to create a conducive investment friendly environment. These include introduction of various laws and rules for the protection of small investors, measures for bringing efficiency and transparency in trade, curbing insider trading, strengthening the structure of the SECP and bringing the market in accordance with international norms. Details of the various policy measures are given below:

- All stock exchanges have been directed to make certain changes in their governance structure to ensure that the exchanges are managed in accordance with internationally accepted norms and in the best interest of the stock market.
- Stock exchanges have been advised to follow international standards in governance.
- The initiatives taken by the SECP are aimed at ensuring that the exchanges conduct themselves as a national institution fully protecting the interests of investors who are major stakeholders in the system.
- The Securities Commission has taken various measures to strengthen the risk management of the stock exchange.
- The net capital balance requirement has been substantially increased to Rs 2.5 million in case of a stock exchange having a turnover of securities exceeding 15.0 billion shares; Rs 1.5 million in case of turnover of securities exceeding 7.5 billion; and Rs 0.75 million in case of turnover of securities not exceeding 7.5 billion.
- Members are required to maintain a capital adequacy ratio, which should be 25 times net capital.
- Up until now, there was no margin required against exposure limits. From November 2000 onwards members are required to deposit 5% margin against their trade within the exposure limits.
- A new set of rules have been announced, in January 2001, to ensure smooth operation of Employees Stock Options. It would be ensured that employees are motivated to have greater share in the companies stock.
- The SECP has finalized the draft regulations for venture capital companies and venture capital fund and the Government has already announced seven years tax-holiday for IT companies. The State Bank of Pakistan has also decided to provide funds to IT companies on inter-bank rate.
- Blank selling has been restrained from inter-settlement carry over. All outstanding trades are required to be settled and no carry over is allowed unless the possession of shares is evidenced. This action would prevent volatility in price fluctuation; and stabilize the market. This restriction was extended to all listed companies as of December 4, 2000.
- The SECP has prepared guidelines for small investors against various market risks and published in newspapers for raising public awareness.
- The Securities Commission has set up a Monitoring and Surveillance Wing. The Surveillance Wing carries out on line monitoring of the stock exchange to effectively monitor the activities at the exchange and to take corrective measures as and when needed.

- A complaint cell has been established in SECP and during July-December 2006, 697 complaints were received out of which 681 complaints were redressed.
- The SECP has streamlined the procedure for issuance of TFCs by reducing cost and simplifying procedure of approval. Stock exchange listing fee, brokerage commission and banker's fee to the issue commission has been reduced. Self-registration has been allowed. TFCs can be issued in tranches. Publication of abridged prospectus has been allowed; and Trustee's responsibilities have been more clearly defined.
- The SECP has notified and prescribed cost accounting records for companies engaged in production of cooking oil, ghee, and cement to, inter-alia, facilitate audit process. Similar rules for sugar industry have been made for which public opinion is being solicited. Draft Rules on disclosure for fertilizer and pharmaceutical industries have been proposed for discussion with the industry.
- Consultative process with trade and professional bodies has been initiated in respect of quarterly reports to be published by the listed companies.
- Further disclosure requirements would be prescribed on the basis of recommendations of the consultants under CMDPL.
- Two new International Accounting Standards have been adopted.
- The SECP has already created an Enforcement Division under a full-fledged Commissioner who is monitoring the performance of listed companies.

7.4 FUTURE DEVELOPMENT PROGRAMS:

For future development of stock market in Pakistan the SECP has initiated the following road map:

- Brokers agent registration regulations would enable direct controlling of brokerage activities. It would enable smooth operation of stock market serve as tool for investor protection. These rules have been finalized and awaiting notification after clearance from the Law & Justice Division.
- For curbing the use of insider information, guidelines are being developed for prohibition of insider trading in the securities of listed companies..
- To broad base the stock market, linkages to cities other than Karachi, Lahore and Islamabad are to be established. The SECP is in the process of developing a policy framework so that the operation is extended to other major cities.
- Software at all the stock exchanges is to be up-graded so that trade from small cities through the communication linkage is facilitated. An appropriate system design is to be prepared on the above basis.
- A complete guide has been prepared which would be published by the SECP and would be made available to the general public at a nominal cost.
- The SECP has a plan to strengthen its investigative unit by induction of properly qualified and trained staff for such purpose.
- The SECP is designing a system for Internet trading along with a regulatory framework.
- Necessary amendments in the existing software at the three stock exchanges regarding automated trading would be made so as to facilitate Internet trading.

7.5 CENTRAL DEPOSITORY COMPANY

Central Depository Company of Pakistan Limited (CDC) was incorporated in 1993 to manage and operate the Central Depository System (CDS). CDS is an electronic book entry system to record and transfer securities. Electronic book entry means that the securities do not physically change hands and the transfer from one client account to another takes place electronically. An IBM led consortium along with the management of the company implemented CDS in Pakistan.

The aim of CDC is to operate as a central securities depository on behalf of the financial services industry so as to contribute to the country's ability to support an effective stock market system which will attract institutional and retail level investors from Pakistan and abroad.

The mission of CDC is to operate and maintain an electronic book entry settlement system for equity, debt and other financial instruments and to contribute to the country's ability to support and develop the Pakistani Stock market as the hub of financial activities in the region. Their goals are to eliminate paper based settlement, to diversify our services, and become a leading institution of the region.

a. Problems Faced by the Stock markets before CDS:

Since the last decade, the stock markets of Pakistan have witnessed a substantial growth leading to a manifold increase in the trading volume. The custody and safe keeping of physical certificates required maintenance of huge vaults by the individuals and institutions and the physical settlement of certificates was no longer feasible. Moreover, the manual system was also plagued by lengthy delays, risks of damage, forgeries and considerable time and capital investment.

Following is a list of the major problems faced by the Members of the Stock Exchange, Investors, Issuers of Securities and others are as follows:

a) Increased volume of book keeping and paper work.
b) Problems in settlement due to increased volume.
c) Maintenance of huge vaults for safe keeping of certificates.
d) Long and cumbersome share transfer procedure taking up to 45 days.
e) Payment of stamp duty on share transfers which ranged from 0.1% to 1.5% of the face value.
f) In case of new issues the issuers would take more than two months for the dispatch of certificates to the successful applicants and for the subsequent preparation and verification of transfer deeds.
g) Risks of damaged, lost, forged and duplicate certificates.
h) Lengthy and tedious procedure involved in pledging of physical securities.
i) Capital and time investment required for issue and dispatch of share certificates, cash dividend, bonus and right issues.
j) Issuance of duplicate certificates.
k) Activities carried out for share transfer during book closure:
l) Signature verification
m) Checking correct value of transfer stamps

n) Verifying genuineness of certificates
o) Signature of Director for confirmation of transfer

The answer to all these questions was to set up an electronic book entry system in Pakistan. This led to the establishment of Central Depository Company of Pakistan Limited developed to manage and operate the Central Depository System (CDS).

b. Benefits of Electronic Settlement through CDS:

Following are some of the benefits of electronic settlement of securities through CDS:

a) Reduced workload due to paperless settlement.
b) Reduced manpower and requirements.
c) Instantaneous transfer of ownership.
d) No stamp duty on transfers in CDS.
e) No risk of damaged, lost, forged or duplicate certificates.
f) No impact in case of sudden increase of settlement volumes.
g) Instant credit of bonus, rights and new issues.
h) Substantial reduction of paperwork during book closure.
i) Convenient pledging of securities.
j) Substantial reduction in time & capital investments

c. AKD Trade – The First Online Investment Site from Pakistan

AKD trade is an online investment site dealing with the investments made in Pakistani stocks exchanges. This site has provided an opportunity for the small investors to invest in to the stock markets.

AKD Trade is Pakistan's first Online Trading site that enables investors to trade at the Karachi Stock Exchange using their PCs from anywhere at any time. AKD Trade started operations in November, 2002 and has since received an overwhelming response from investors. A division of AKD Securities, Pakistan's largest stock brokerage firm, AKD Trade's mission is to provide retail investors maximum access to Pakistan's capital markets. AKD Trade is the first fully automated order processing system for stock trades in the country. AKD Trade has made stock trading simpler, faster, transparent and cheaper for the retail investor. AKD Trade is an e-business in the truest sense and in its first year of operations, has already received an overwhelming response from the retail investor base of the Karachi Stock Exchange. AKD Trade has also contributed significantly in increasing the retail base at the Karachi Stock Exchange. After the first 12 months, over 1 billion shares have been traded using the AKD Trade Online Trading System.

Mission:

“To provide retail investors maximum access to Pakistan's capital markets”

AKD Trade is proud to have in place a fully automated Settlement system along with the only automated Risk Management system in the country, which ensures healthy equity portfolios both for clients and the business. Within a year, AKD Trade has managed to elevate the standards of the Stock Trading business to a level unimagined in the past by either the Members or investors at the Stock Exchange.

AKD Trade, a responsible member of the Service Industry, is obligated to provide new and enhanced tools of access along with a high standard of customer service. AKD Trade has several initiatives planned for the future, such as trading via mobile phones, a 24x7 x365 Call Centre, a country-wide branch network allowing convenient access to investors, and a whole lot more.

In essence, AKD Trade has brought the stock exchange to the computer screen of the investor, enabling order placement at the Stock Exchange with utmost ease. In addition to broadening the investor base of the Karachi Stock Exchange, this initiative has also helped in strengthening the capital markets of Pakistan. It is a huge step forward towards creating the right opportunities for investors to make investment decisions with convenience and towards building an investor-friendly environment in the country.

Chapter 8

RECOMMENDATION

FLOAT ISLAMIC BONDS INSTEAD OF EUROBONDS (DEBT CERTIFICATE)

IDEAL CRITERIA OF ISSUING OF ISLAMIC BONDS.

1. No interest should be paid on these bonds.
2. Should not increase the debt burden of Govt. as these will be sold in the open market without interest so no guarantee is required unlike Euro bonds.
3. Should be available on supply and demand bases at all times with no restriction on the amount.
4. Should benefit everybody when used with or without real currency to purchase anything in the Govt. or Private sector.
5. Cannot be hoarded and should be available from different sources but the rate might vary from day to day and from place to place. So the buyer has a choice to purchase it at the cheapest price.
6. Everybody should have the opportunity to buy at the cheapest rate when these bonds are floated by Govt. but as usually well to do persons can buy more quantities than average or poor person, which is not against Islam.
7. Buying and selling of bonds will be like any other commodity but differ form other commodity, as these will never be in short supply.
8. Should have unlimited shelf life.
9. Inter bank rate on daily, weekly or monthly basis will be as for actual currency but without interest.
10. Because of very strong incentive of profit Govt. will sell these shares in trillions of Rs. every year and hence there will be massive revenue collection by Govt. early in fiscal year and also throughout the year.
11. Strong incentive to buy the bonds through foreign currency will result in massive reserve in hard currency by the Govt.

12. Prize draw of millions of Rs. from the profit earned by Islamic way every day.
13. No kickbacks in millions of dollars to sell like Eurobonds, which will only benefit few at the top.
14. As no question is asked, all kinds of black money will be used to purchase these bonds and hence will give massive amount of cash flow to Govt. to invest in projects like dams to produce electricity and exploration of oil, gas fields and minerals thus making the country self sufficient in every way.
15. All spare and unused money or valuable will be used to buy these bonds for business purposes and to reduce the cost of all kinds of bills and commodities of daily use.
16. When purchased even at the most expensive rate should reduce the price of goods or services from 10 to 20% and at least 50% from the present price when purchased at the cheapest rate.
17. Should provide job opportunities to millions of unemployed and educated persons to sell these bonds on commission basis.
18. Options should be available to open bank accounts with all the facilities like real money.
19. Also available in the form of debt cards to be used in most places where machines are available.
20. Should be available at the cheapest rate though Govt. to all kinds of business throughout the year provided they are registered.
21. Buying facility available 24 hours, 365 days at thousands of offices of the selling agency.
22. Unlimited purchase option available from selling agency or from the pen market without any question asked.
23. Should create continuous business euphoria involving every individual irrespective of the status so that even the poorest person should be able to buy and sell at profit margin.
24. Options available for duty free goods by surrendering the bonds throughout the year.
25. These are the magic bonds called shares or coupons used in MBC System and these will meet all the criteria mentioned above.

26. Now, compare these Islamic Bonds with the present bonds and all kinds of other debt certificates presently being floated.
27. Sale of these bonds will help to recover and reduce the extra currency printed without guarantees in the past.
28. The net affect of sale of these bonds will result in reducing the inflation rate of the country.
29. The value of Rupee appreciates against the foreign currency, which will help to reduce the foreign debts.
30. This will also help in industrial boom and ultimately export will increase and imports will decrease this will result in reversing in the import and export ratio presently running two billion dollar of deficit every year.

CHAPTER 9

CONCLUSION

Islam is not against speculation if it is made by genuine investors who have worked hard and analysed the macro-and micro-economic and financial fundamentals, and therefore have the right to speculate once the environment at the stock exchange is conducive to do so. On the contrary, what Islam is against is insider trading and the role of rumours, whose main interests are to manipulate the market and force their counterparts (the genuine investors) to sell of their shares at lower prices, Islam categorically condemns that, because such actions will undoubtedly bring harm to others and to the society as a whole.

Islam has clearly emphasized that for any financial transaction between two parties or more, a person should not do harm to others while others should not do harm to him. It is for the policymakers to examine the above proposal to promote the SMEs and make them competitive and efficient to achieve Vision 2020.

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

Glossary

al-wadiah = safe keeping

bai'muajjal = deferred-payment sale

bai'salam = pre-paid purchase

baitul mal = treasury

fiqh = jurisprudence

Hadith = Prophet's commentary on Qur'an

hajj = pilgrimage

halal = lawful

haram = unlawful

ijara = leasing

iman = faith

mithl = like

mudaraba = profit-sharing

mudarib = entrepreneur-borrower

muqarada = mudaraba

murabaha = cost-plus or mark-up

musharaka = equity participation

qard hasan = benevolent loan (interest free)

qirad = mudaraba

rabbul-mal = owner of capital

riba = interest

Shariah = Islamic law

shirka = musharaka

Appendix 'A'

List of Islamic Financial Institutions (outside Pakistan and Iran)

Australia Islamic Investment Company, Melbourne.

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

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

Bangladesh Islamic Bank of Bangladesh Ltd, Dhaka.

Denmark Islamic Bank International of Denmark, Copenhagen.

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

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

India Baitun Nasr Urban Cooperative Society, Bombay.

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

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

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

Liberia African Arabian Islamic Bank, Monrovia.

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

Luxembourg Islamic Finance House Universal Holding S.A.

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

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

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

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

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

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

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

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

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1 Surah al-Rum (Chapter 30), verse 39

2 Surah al-Nisa (Chapter 39), verse l6l

3 Surah al-Imran (Chapter 3), verses 2-l30

4 Surah al-Baqarah (Chapter 2), verses 81-275
(Yusuf Ali's Translation of the Qur'an).

5 Hadith : Kitab al-Musaqat.