

**Emerging Trends in Islamic  
Banking**

**By: M Junaid Khan**  
MBA-2004

## **Acknowledgements**

I am thank full to Allah Almighty for helping me in completing this research report. I am also thankful to my faculty members and specially my thesis advisor for providing timely guidance at all point where I faced difficulties. I am also great full to my friends and family for supporting me during my research work. May Allah bless them all. Amen.

## **EXECUTIVE SUMMARY:**

Islamic banking has seen tremendous growth in the past two decades. The growth is due to various modes of Islamic finance. The basis of the traditional banking is based on the concept of debt and interest. In contrast the Islamic banking and finance modes draws its roots from the Islamic Shariah.

While looking at the Islamic modes of finance it should be kept in mind that it is not solely practiced in Islamic countries or by Muslims. If we look at the new trends in the finance, we find out that the modes such as Venture Capital Finance and Securitization of the Islamic modes emerged from the western countries. The venture finance companies of the USA have billions of dollars at their disposal. At present the US is the biggest market for the venture funds. Development of this concept in Islamic finance would open up an arena of unlimited opportunities for Islamic financial institutions.

The need of the hour is to implement these emerging trends in the Islamic banking and finance paradigm. In this concern the role of the State bank is of enormous value. In the past few years State bank has formed various policies to regulate and develop the Islamic finance market. Even the operations of State Banks can be run under the Islamic financial system. This thesis has explored many such topics in detail.

In the end, this research paper gives recommendations as to how this system can be further improved by taking certain steps. In the long run, one can easily predict this system to prevail as its basic concept is to eliminate the unjust exploitation of the needy and poor people of the society.

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**ABSTRACT**

Islamic banking has seen tremendous growth in the past two decades. The growth is due to various modes of Islamic finance. The basis of the traditional banking is based on the concept of debt and interest. In contrast the Islamic banking and finance modes draws its roots from the Islamic Shariah.

While looking at the Islamic modes of finance it should be kept in mind that it is not solely practiced in Islamic countries or by Muslims. If we look at the new trends in the finance, we find out that the modes such as Venture Capital Finance and Securitization of the Islamic modes emerged from the western countries. The venture finance companies of the USA have billions of dollars at their disposal. At present the US is the biggest market for the venture funds. Development of this concept in Islamic finance would open up an arena of unlimited opportunities for Islamic financial institutions.

The need of the hour is to implement these emerging trends in the Islamic banking and finance paradigm. In this concern the role of the State bank is of enormous value. In the past few years State bank has formed various policies to regulate and develop the Islamic finance market. Even the operations of State Banks can be run under the Islamic financial system. This thesis has explored many such topics in detail.

In the end, this research paper gives recommendations as to how this system can be further improved by taking certain steps. In the long run, one can easily predict this system to prevail as it basic concept is to eliminate the unjust exploitation of the needy and poor people of the society.

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# **CHAPTER 1: INTRODUCTION**

## **1.1 History of Banking:**

A simple form of banking was practiced by the ancient temples of Egypt, Babylonia, and Greece, which loaned at high rates of interest the gold and silver deposited for safekeeping. Private banking existed by 600 B.C. and was considerably developed by the Greeks, Romans, and Byzantines. Medieval banking was dominated by the Jews and Levantines because of the structure of Christian Church against interest and because other occupations were largely closed to Jews. The forerunners of modern banks were frequently chartered for a specific purpose, e.g., the Bank of Venice (1171) and the Banks of England (1694), in connection with loans to the government; the Bank of Amsterdam (1609), to receive deposits of gold and silver. Banking developed rapidly throughout the 18<sup>th</sup> and 19<sup>th</sup> century, accompanying the expansion of industry and trade, with each nation evolving the distinctive forms peculiar to its economic and social life.

## **1.2 Types of Banks:**

Banks have traditionally been distinguished according to their primary functions. Commercial banks, which include national and state chartered banks, trust companies, stock savings banks, and industrial banks, have traditionally rendered a wide range of services in addition to their primary functions of making loans and investments and handling demand as well as savings and other time deposits. Mutual saving banks until recently, accepted only savings and other time deposits, and offered limited types of loans and services. The fact that commercial banks were able to expand or contract their loans and investments in accordance with the changes in reserves and reserve requirements further differentiated them from mutual savings banks, where the volume of loans and investments was governed by changes in customer's deposits.

### **1.3 Other Financial Institutions:**

Types of financial institutions that have not traditionally been subject to the supervision of state or federal banking authorities but that perform one or more of the traditional banking functions are saving and loan Associations, mortgage companies, finance companies, insurance companies, credit agencies owned in whole or in part by the federal government, credit unions, brokers and dealers in securities, and investment bankers. Savings and loan associations, which are state institutions, provide home-building loans to their members out of funds obtained from savings deposits and from the sale of shares to members. Finance companies make small loans with funds obtained from invested capital, surplus, and borrowings. Credit Unions, which are institutions owned cooperatively by groups of persons having a common business, fraternal, or other interest, make small loans to their members out of funds derived from the sale of shares to members. The primary functions of investment bankers are to act as advisers to governments and corporations seeking to raise funds, and to act as intermediaries between these issuers of securities, on the one hand, and institutional and individual investors, on the other.

### **1.4 International Banks:**

The International Bank for Reconstruction and Development (World Bank) was organized (1945) to make loans both to governments and to private investors. The discharge of debts between nations has been simplified and facilitated through the International Monetary Fund (IMF), which also provides members with technical assistance in international banking. The former European Monetary Agreement also made possible the rapid discharge of debts and balance of payments obligations between nations. The European Central Bank was established in 1998 to help formulate the joint monetary policy of those European Union nations adopting a single currency.

## **1.5 Islamic Banking:**

Islamic banks appeared on the world scene as active players over two decades ago. But "many of the principles upon which Islamic banking is based have been commonly accepted all over the world, for centuries rather than decades. With the passage of time, Islamic Banking has developed considerably and today almost all countries in the world have Islamic Banks. Moreover, the Islamic Banking field itself has expanded and each new day, new products are offered that are in strict compliance with the principals of Islam.

## **1.6 Scope of the Study:**

This study has been done from a broader perspective on Islamic Financial system and the emerging trends in this area. Moreover, this study is not a country specific rather it takes on a global perspective and focuses on the emerging issues in Islamic Financial System. The analysis has been done from global perspective and focuses on the issues rather than geographic location. The conclusion and recommendation are generally applicable to the whole industry and hence are good for any geographic location.

## **1.7 Research Methodology:**

The following methods have been used in collection of data for this research thesis.

### **1.7.1 Executive Interviews:**

I contacted a number of executives of different banks who are currently working on implementation of Islamic Financial System in their respective banks.

### **1.7.2 Internet Survey:**

I used internet as a source of collecting information for my thesis. I searched a wide variety of websites both for local and foreign research carried out on emerging issues in Islamic finance.

### **1.7.3 News Paper and Articles:**

I searched a number of Local as well as international journals like financial times and business recorder as well as local news papers like the Daily dawn as a source of secondary information.

### **1.7.4 Books and Academic Papers:**

I also skimmed through my notes and academic papers while collecting information for compiling my paper. They served an important purpose by giving me an even more clear understanding of the topic.

## **1.8 Hypothesis & Limitations:**

This thesis will test the basic hypothesis statement which can be framed as follows:

“Are the new trends and issues in Islamic Financial System feasible for implementation and do they cope up with the modern day industry demand?”

This research is an effort to test this hypothesis statement as framed above. However there are always a few limitations as to the testing, data gathering and framing the assumptions. Main limitations of the various techniques are as follows:

- Scholars tend to disagree on the interpretation of different Ayaths and Hadiths.
- Two main systems of Islamic Financial system are actively working with slight differences; hence working out for a neutral solution becomes difficult.
- Internet Search provided information for the distant past

## **CHAPTER 2: LITERATURE REVIEW**

### **Efficiency in Islamic Banking: an Empirical Analysis of 18 Banks by Donsyah Yudistira. August 20, 2003**

In this paper, technical, pure technical, and scale efficiency measures are calculated by utilizing the non-parametric technique, Data Envelopment Analysis. Several conclusions emerge. First, the overall efficiency results suggest that inefficiency across 18 Islamic banks is small at just over 10 percent, which is considerable compared to many conventional counterparts. Similarly, Islamic banks in the sample suffered from the global crisis in 1998-1999 but performed very well after the difficult periods. This would suggest that the interdependence of Islamic banks to other financial system is still closely related and any regulator, especially in which the bank operates, should consider Islamic banking in the search of global financial stability.

Second, the findings further indicate that there are diseconomies of scale for small-to medium Islamic banks which suggests that M&A should be encouraged. Supported by the non-parametric technique and regression analysis, Islamic banks within the Middle East region are less efficient than their counterparts outside the region. Additionally, market power, which is common in the Middle East, does not significantly have an impact on efficiency. The reason is that Islamic banks from outside the Middle East region are relatively new and very much supported by their regulators<sup>6</sup>. Furthermore, publicly listed Islamic banks are less efficient than their non-listed counterparts.

### **A Basic Guide to Contemporary Islamic Banking and Finance by Mahmoud Amin El-Gamall, Rice University. June 2000**

The educational aims of this work are two-fold: First it alerts Muslims to the differences between conventional and Islamic finance, and to boost the efforts of the sincere Muslims developing or dealing with Islamic financial institutions.

Secondly it provides a clear basic understanding of the underlying contracts; Muslims may become less prone to making inadvertent errors, as well as less likely to fall prey to the inevitable exploitative efforts of some unscrupulous individuals.

Mahmoud Amin El-Gamall has successfully explained the thin line difference between Islamic Finance and conventional finance for the generalists, who pay little attention to minute details. It has helped Muslims, particularly in Western Societies, to differentiate between Islamic mode of finance and its conventional form.

**Concept of Time in Islamic Economics. From: Islamic Economic Studies Vol.2 No.1 1415H (1994) By Ridha Saadallah**

This paper briefly touches on the different arguments for and against the time value of money in Islam. It not only touches the time value of money in interest but also in case of deferred payments in sales. It provides both sides of the argument but concludes by saying that "Provisions of sales and loans in Islamic jurisprudence fall within a single concept of time where time is recognized as having an economic value. However, time may be treated differently in sales and loans for reasons we indicated above to the best of our knowledge, although ultimate knowledge rests with the Almighty God of all creation.

**"Islamic Banking-A Practical Guide", written by Dr. Muhammad Imran Ashraf Usmani Ph. D. in Islamic Finance. Assistance in translation, editing and compilation by Zeenat Zubairi.**

This guide has been written for the purpose of helping people in Pakistan to cope up with the new challenges in Islamic Banking. The author has touched upon all the important areas and practical insights into most of the instruments offered by Islamic Banks. This guide is helping many people in the field. It will help me in my research by providing strong foundation.

**"The Role of Venture Capital in Contemporary Islamic Finance" By Tariq Al-Rifai – The International Investor, Kuwait and Aamir Khan – ABN AMRO, Chicago IL**

In this paper, Mr. Tariq Al-Rifai has given an insight into the Venture Finance. He has compared the traditional venture capital and the different type of instruments used in it. He later compared those instruments with the Islamic Shariah, and identified all those instruments which are Shariah compliant. This paper provides a guideline for further research into this emerging sector of Islamic financial industry by effectively analyzing all its sub segments individually.

## **CHAPTER 3: SHARIAH AND ISLAMIC BANKING:**

### **3.1 Prohibition of Riba in Quran and Sunnah:**

Riba has been banned by Islam. The following verses from the Quran and Sunnah verifies the ban imposed on riba.

#### **3.1.1 Riba in the Qur'an:**

**1. First Revelation (Surah al-Rum, verse 39)**

"That which you give as interest to increase the peoples' wealth increases not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold."  
(30: 39)

**2. Second Revelation (Surah al-Nisa', verse 161)**

"And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples' property. We have prepared for those among them who reject faith a grievous punishment (4: 161)"

**3. Third Revelation (Surah Al 'Imran, verses 130-2)**

"O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy."

**4. Fourth Revelation (Surah al-Baqarah, verses 275-81)**

"Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist, may keep their previous gains, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein for ever." (275)

"God deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner." (276)

"Those who believe, perform good deeds, establish prayer and pay the zakat, their reward is with their Lord; neither should they have any fear, nor shall they grieve." (277)

"O, believers, fear Allah, and give up what is still due to you from the interest (usury), if you are true believers." (278)

"If you do not do so, then take notice of war from Allah and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it." (279)

"If the debtor is in difficulty, let him have respite until it is easier, but if you forego out of charity, it is better for you if you realize." (280)

"And fear the Day when you shall be returned to the Lord and every soul shall be paid in full what it has earned and no one shall be wronged." (281).

### **3.1.2 Riba in Hadith:**

1. From Jabir : The Prophet, ﷺ, may cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike [in guilt]." (Muslim, Kitab al-Musaqat, Bab la'ni akili al-riba wa mu'kilihi; also in Tirmidhi and Musnad Ahmad)

2. Jabir ibn 'Abdallah , giving a report on the Prophet's Farewell Pilgrimage, said: The Prophet, ﷺ, addressed the people and said "All of the riba of Jahiliyyah is annulled. The first riba that I annul is our riba, that accruing to 'Abbas ibn 'Abd al-Muttalib [the Prophet's uncle]; it is being cancelled completely." (Muslim, Kitab al-Hajj, Bab Hajjati al-Nabi, ; may also in Musnad Ahmad)

3. From 'Abdallah ibn Hanzalah : The Prophet, ﷺ, said: "A dirham of riba which a man receives knowingly is worse than committing adultery thirty-six times" (Mishkat al-Masabih, Kitab al-Buyu', Bab al-riba, on the authority of Ahmad and Daraqutni).

Bayhaqi has also reported the above hadith in Shu'ab al-iman with the addition that "Hell befits him whose flesh has been nourished by the unlawful."

4. From Abu Hurayrah : The Prophet, , said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest." (Ibn Majah, Kitab al-Tijarat, Bab al-taghlizi fi al-riba; also in Musnad Ahmad)

5. From Abu Hurayrah : The Prophet, , said: "Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother." (Ibn Majah)

### **3.2 Riba and its Type:**

#### **Definition of Riba or Interest**

The word "Riba" means excess, increase or addition, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

This definition of Riba is derived from the Quran and is unanimously accepted by all Islamic scholars. There are two types of Riba, identified to date by these scholars namely 'Riba An Nasiyah' and 'Riba Al Fadl'.

'Riba An Nasiyah' is defined as excess, which results from predetermined interest (sood) which a lender receives over and above the principle (Ras ul Maal)

'Riba Al Fadl' is defined as excess compensation without any consideration resulting from a sale of goods. 'Riba Al Fadl' will be covered in greater detail later.

During the dark ages, only the first form (Riba An Nasiyah) was considered to be Riba. However the Holy Prophet also classified the second form (Riba Al Fadl) as Riba.

The meaning of Riba has been clarified in the following verses of Quran:

"O those who believe, fear Allah and give up what still remains of the Riba if you are believers. But if you do not do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the right of the return of your capital; neither will you do wrong nor will you be wronged." Al Baqarah 2:278-9

These verses clearly indicate that the term Riba means any excess compensation over and above the principal which is without due consideration. However, the Quran has not altogether forbidden all types of excess; as it is present in trade as well, which is permissible. The excess that has been rendered haram in Quran is a special type termed as Riba. In the dark ages, the Arabs used to accept Riba as a type of sale, which unfortunately is also being understood at the present times. Islam has categorically made a clear distinction between the excess in capital resulting from sale and excess resulting from interest. The first type of excess is permissible but the second type is forbidden and rendered Haram.

"Seized in this state they say: 'Buying and selling is but a kind of interest', even though Allah has made buying and selling lawful, and interest unlawful." Al Baqarah 2:275

### **Classification of Riba**

1. The first and primary type is called Riba An Nasiyah or Riba Al Jahiliya.
2. The second type is called Riba Al Fadl, Riba An Naqd or Riba Al Bai.

Since the first type was specified in the Quranic verses before the sayings of the Holy Prophet , this type was termed as Riba al Quran. However the second type was not understood by the Quranic verses alone but also had to be explained by the Holy Prophet , it is also called Riba al Hadees.

### **Riba An Nasiyah**

This is the real and primary form of Riba. Since the verses of Quran has directly rendered this type of Riba as haram, it is called Riba Al Quran. Similarly since only this type was considered Riba in the dark ages, it has earned the name of Riba Al Jahiliya. Imam Abu

Bakr Hassas Razi has outlined a complete and prohibiting legal definition of Riba An Nasiyah in the following words:

"That kind of loan where specified repayment period and an amount in excess of capital is predetermined."

One of the ahadith quoted by Ali ibn at Talib (RAA) has defined Riba An Nasiyah in similar words. The Holy Prophet said:

"Every loan that draws interest is Riba."

The famous Sahabi Fazala Bin Obaid has also defined Riba in similar words:

"Every loan that draws profit is one of the forms of Riba"

The famous Arab scholar Abu Ishaq az Zajaj also defines Riba in the following words:

"Every loan that draws more than its actual amount"

Riba An Nasiyah refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. The prohibition of Riba An Nasiyah is one of those issues which have been confirmed in the revealed laws of all Prophets (AS). Some of the old testaments has rendered Riba as haram (See Exodus 22:25, Leviticus 25:35-36, Deutronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12). The Quran has also stated the prohibition of Riba in various verses and has warned those who persist in practicing it of a war which is certain to be declared on them by Allah Himself and His messenger and has seriously threatened those engaged as writer, witness and dealer in Riba transactions. These verses and ahadith will be discussed at length in a separate chapter called "The prohibition of Riba in the light of Quran and hadith".

The fact that Riba An Nasiyah is categorically haram has never been disputed in the Muslim community.

In short, the Riba of today which is supposed to be the pivot of human economy and features in discussions on the problem of interest is nothing but this Riba, the unlawfulness of which stands proved on the authority of the seven verses of the Quran, of more than forty ahadith and of the consensus of the Muslim community.

### **Wisdom behind the prohibition of Riba An Nasiyah**

First of all, we should realize that there is nothing in the entire creation of the world, which has no goodness or utility at all. But it is commonly recognized in every religion and community that things which have more benefits and less harms are called beneficial and useful. Conversely, things that cause more harm and less benefit are taken to be harmful and useless. Even the noble Quran, while declaring liquor and gambling to be haram, proclaimed that they do hold some benefits for people but the curse of sins they generate is far greater than the benefits they yield. Therefore, these cannot be called good or useful; on the contrary, taking these to be acutely harmful and destructive, it is necessary that they be avoided.

The case of Riba An Nasiyah is not different. Here the consumer of Riba does have some casual and transitory profits apparently coming to him, but its curse in this world and in the Hereafter is much too severe as compared to this benefit. The Riba consumer suffers such a spiritual and moral loss that it virtually takes away the great quality of being 'human' from him. An intelligent person who compares things in terms of their profit and loss, harm and benefit can hardly include things of casual benefit with an everlasting loss in the list of useful things. Similarly no sane and just person will say that personal and individual gain which causes loss to the whole community or group is useful. In theft and robbery for example, the gain of the gangster and the take of the thief is all too obvious but it is certainly harmful for the entire community since it ruins its peace and sense of security.

### **Riba Al Fadl**

The second classification of Riba is Riba Al Fadl. Since the prohibition of this Riba has been established on Sunnah, it is also called Riba Al Hadees.

Riba Al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase & sale as explained in the famous hadith: The Prophet said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (Riba). However, sell gold for silver anyway you please on the condition it is hand-to-hand (spot) and sell barley for date anyway you please on the condition it is hand-to-hand (spot)."

**This hadith enumerates 6 different commodities namely:**

- 1) Gold**
- 2) Silver**
- 3) Dates**
- 4) Wheat**
- 5) Salt**
- 6) Barley**

These six commodities can only be bought and sold in equal quantities and on spot. An unequal sale or a deferred sale of these commodities will constitute Riba. These six commodities in fiqh terminology are called "Amwal-e-Ribawiya". Does this hadith apply only to the items mentioned in it? Does it concern sales of barley or wheat but not rice? Of dates but not raisins? A complete legal definition differs in every fiqh. Scholars such as Taoos and Qatada hold that Riba Al Fadl includes these specified types only, however a majority of Islamic scholars believe that some other commodities should also be included. In order to answer the question, which other commodities should be included, some fiqhs hold that the characteristics which are common amongst these items can be used as basis (illat) for Riba Al Fadl. An illat is the attribute of an event that entails a particular divine ruling in all cases possessing that attribute; it is the basis for applying analogy. Ribawi goods are therefore goods that exhibit one of the efficient causes occasioning application of Riba rules. Various schools define these causes differently:

## **Imam Abu Hanifa**

Imam Abu Hanifa sees only two common characteristics namely:

- 1) Weight
- 2) Volume

Meaning all these six goods are sold by either weight or volume. Therefore all those commodities, which have weight or volume and are being exchanged, with the same commodity will fall under the rules of Riba Al Fadl.

## **Imam Shafi**

The two characteristics observed by Imam Shafi are:

- 1) Medium of Exchange or
- 2) Eatable

Therefore this law will apply on everything edible or having the natural ability of becoming a medium of exchange (currency).

## **Imam Malik**

Imam Malik identified the following two characteristics:

- 1) Eatables and
- 2) Preservable

## **Imam Ahmad Bin Hanbal**

Three citations have been related to him:

- i) First citation conforms to the opinion of Imam Abu Hanifa.
- ii) Second citation conforms to the opinion of Imam Shafai.

iii) Third citation includes three characteristics at the same time namely edible, weight and volume.

After a detailed study of the above schools of thought, it has been declared by Islamic scholars that if a commodity bears both of the two characteristics namely; it has weight and can be used as a medium of exchange, then the following two kinds of transactions are not allowed when the same goods are being exchanged:

- A deferred sale of goods (A deferred sale is when the goods are returned/or paid for after some undetermined period)
- A sale of unequal quantities of the same goods

However, when only one of the two characteristics is present to term the sale as Riba Al Fadl, then exchange of unequal goods are allowed but deferred sale is not allowed.

Wisdom behind the prohibition of Riba Al Fadl  
The prohibition of Riba Al Fadl is intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back-doors to Riba An Nasiyah because in the Islamic Shariah, anything that serves as a means to the unlawful is also unlawful.

### **3.3 Commercial interest and Usury:**

In the 17th century, two new technical terms of interest emerged after the establishment of banking system, namely:

1. Tijarti Sood (Commercial Interest): Interest paid on loan taken for productive & profitable purposes.
2. Sarfi Sood (Usury): Interest paid on loan taken for personal need and expenses.

### **The background of both types:**

The present day banking system, which has given interest the moral and legal license, is the backbone of the prevalent capitalism. When Muslim countries became subjugated to west in their economic field, some westernized Muslims in the 19th century, on one side, saw the increasing progress of the west in trade and industry and on the other side saw the shattering economic condition of fellow Muslims states. They also became conscious of the fact that banking is inevitable in the field of trade and industry not only on national level but also internationally. This prompted them to say that only usury is haram (illegal) but not commercial interest because rendering commercial interest haram would pose irresolvable problems to their way up to industrialization and economic progress. They only included usury in the term "Riba" as categorically prohibited in Qura'n and sunnah and freed commercial interest from it calling it totally different from the western concept of interest. Therefore, it was concluded that the prohibition of Riba was restricted to usury while commercial interest was perfectly Islamic.

There are two schools of thought on this issue. A detailed analysis of their arguments is discussed as under:

#### **1. First School:**

This school presents two arguments to support their point that only usury (not commercial interest) is prohibited in Islam:

#### **Argument and Counter argument:**

"Riba as practiced during the days of the Prophet was only Usury"

This claim is groundless, since Islam when prohibiting something does not only prohibit one form of it that is prevalent, but all forms that might erupt in future. The changed state does not change the ruling for eg. Qura'n has prohibited the following:

**a) Liquor (Khamar):** During the time of Prophet its form and the way of production was totally different from that of the present day liquor but the ruling remains unchanged even though the form has changed.

**b) Pork (Khinzeer):** Irrespective how clean the present day breeding of pigs in high class farms may be, pork will stay prohibited and cannot be rendered halal (legal).

**c) Corruption/Immorality (Al Fahsha):** Although a lot of sophisticated ways have been developed of this evil from the time of Qura'nic revelations prohibiting it, the ruling stands forever.

The same applies to interest and gambling. By claiming that it was in a different form during Prophet's time does not change its ruling. It remains unchanged just as in case of Khamar, Khinzeer and Al Fahsha.

#### **Argument and Counter argument:**

"Commercial interest did not exist in the days of Prophet"

This claim is also wrong. If one glances through the Islamic and pre Islamic history of Arabia, it will be evident that the interest type at that time was not restricted to usury but loans were granted for commercial and profitable purposes. To quote some examples:

**a)** "The tribe of Umro bin Aamir used to take interest from the tribe of Mughairah. At the advent of Islam, Mughairah owed heavy interest to Umro bin Aamir." In this narration, the transaction of interest between two tribes of Arabia has been pointed out who actually operated as trading companies; both tribes were very wealthy. Could it be that 2 wealthy tribes transacted interest just for personal need and expenses? The interest was simply commercial!

**b)** Therefore in pre Islamic days, we see that Syedna Abbas bin Abdul Muttalib and Syedna Khalid bin Waleed formed a company with joint capital whose prime business was cash advancement on interest. Similarly Syedna Usman was one of the wealthy

businessmen who lent money on interest. There were many other traders dealing full time in interest extending a network of interest based transactions.

## **2. Second School:**

This group present two arguments justifying their point of view that are mentioned below:

### **Argument and Counter argument:**

The factor leading to prohibition of Riba (Interest) is that if a borrower faces a loss, he still has to pay an excess amount over the principal, which is basically an exploitation of his need whereas the lender on the other hand gets an increase on his surplus capital without any effort which is unjust. But this factor is not found in commercial interest since both the borrower as well as the lender gets profit; the borrower on the amount he has circulated in business and the lender in shape of interest over his principle amount. Therefore, no one faces unfairness or injustice in this transaction.

This argument is quite appealing and attractive at the face value, as it is based on the assumption that no one suffers in case of commercial interest. But after analysis, it is proven that Quran has not only prohibited that one party faces a loss and the other gets profit but has also prohibited one party getting confirmed profit and the other party unconfirmed profit from the same investment as we have studied above in the case of Mokhabara.

### **Another clear argument:**

Syedna Abu Hurairah narrated that the Prophet said, "He who does not abandon Mokhabara, will be caught in a war against Allah & His Prophet."

In this narration Prophet has rendered Mokhabara illegal just like riba and has declared a war against those who indulge in it just like riba.

## **What is Mokhabara?**

Its actually a division of the crop by agreement between the landlord and cultivator in which the landlord gives his land to cultivator for cultivation purposes in order to get his pre-agreed amounts of the crop irrespective whether the production is low or high. For eg. "A" lends his land to 'B' for cultivation on the condition that he will get a predetermined portion on each crop eg. 5 mounds. Such a transaction is called Mokhabara.

Prophet had called Mokhabara a form of riba. Now one should think over whether he referred to usury as the form of riba or he referred to commercial interest. It is similar to commercial interest as both Mokhabara and commercial interest are used for productive businesses. Whereas in the case of usury, the borrower uses the loan for personal use and not productive purposes.

To sum up, Prophet included Mokhabara in riba that has no similarity with usury, rather with commercial interest. The fact that during Prophet's time, the dealing in commercial interest was common is proven and also that this form is prohibited.

### **3.4 Simple and Compound interest:**

Riba an Nasiyah can be classified into two types:

- **Simple Interest ( Sood-e-Mufrid)**
- **Compound Interest (Sood-e-Murakkab)**

#### **Definition of Simple Interest:**

Interest calculated only on the initial investment.

#### **Definition of Compound Interest:**

Reinvestment of each interest payment on money invested, to earn more interest.

During the pre-Islamic era, when a borrower used to fail to pay back the principal and interest charged on him, then the lender used to extend the loan on the condition that the

interest will also become part of the loan (essentially Compound Interest). The following verses of Quran were revealed in order to stop the people from such practices:

"O believers, take not doubled and redoubled interest, and fear God so that you may prosper." (Surah Al 'Imran, verses 130-1)

To eradicate this abominable practice of the period of ignorance, this verse was revealed. By mentioning the practice of doubling and redoubling, it was condemned and declared unlawful in view of its adverse impact on the community and the selfishness that it bred. It does not mean that if there is no doubling and redoubling (i.e., if there is simple interest, in today's jargon), then it is lawful. No. In Surah Al Baqarah (The Cow) and Surah An Nisa (The Women), the prohibition of interest in its entirety and in absolute terms is clearly mentioned, whether or not there is doubling and redoubling.

Since the aforementioned verse prohibits the compound interest only, some people misinterpret it even today that compound interest alone is forbidden in Islam, not the simple interest. They fail to see that there is absolute prohibition of simple interest in a number of other Quranic verses. The reason that the above verse specifically uses the words "doubled and redoubled interest " is to highlight the shameful aspect of compound interest and not to limit the scope of riba only to compound interest. This is similar to Allah's command "Do not bargain on my orders for paltry gains in this world." The reason for mentioning paltry gains is that even if all conceivable material goods and luxuries of this world are obtained in exchange for ignoring Allah's commands, even then this is a paltry gain. It does not obviously mean that it is prohibited to obtain paltry gains but permissible to obtain (by one's standard or judgment) a hefty price. Similarly, in the Ayat under consideration, the mention of doubling and redoubling is to condemn the shameful practice rather than limit its permissibility.

### **Verses on absolute prohibition of Simple and Compound Interest**

"O believers, fear God and give up the interest that remains outstanding (i.e. whether it is simple interest or multiplied interest) if you are believers."  
**(Surah Al-Baqarah, verse 278)**

"If you do not do so, then be sure of being at war with God and His Messenger. But, if you repent, you can have your principal (only - not any kind of interest or premium). Neither should you commit injustice nor should you be subjected to it. **(Surah al Baqarah, verse 279)**

The above two verses demand to abandon the amount of riba and directs that only the principal amount should be paid back, nothing in excess. The second verse explains that any excess on principal, no matter how insignificant, is cruel.

The following hadith also proves that both simple and compound interest are forbidden:

"Listen! all Riba liable to you in the pre-Islamic days have been completely eliminated. You have to pay back the principal amount only. Neither hurt someone nor get hurt by someone. And the first riba to be completely eliminated is Abbas bin Mutalib's.

The above evidence proves that the claim that 'only compound interest is prohibited and any riba less than that is allowed in Islam,' is wrong. Any amount in excess of the principal fixed in the contract of a loan is called Riba An Nasiyah. If simple interest is accepted, it can also be used to give out additional loans, which will again pay out simple interest. In effect, the interest will keep on becoming part of the principal, which is essentially compound interest.

### **The Prohibition of Gharar**

There are numerous Hadiths forbidding *Gharar* sales, and specific instances thereof. One commonly cited Hadith was narrated by Muslim, Ahmad, Abu Dawud, Al Tirmidhi, Al-Nasai, Al-Darami and 'Ibn Majah on the authority of Abu Hurayra (mAbpwh) (translation of the version in Muslim) that The Prophet (pbuh) prohibited the pebble sale and the *Gharar* sale. A good translation of *Gharar* is "risk" or "uncertainty". Professor Mustafa Al-Zarqa defined it as follows: *Gharar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling. Many classical examples of *Gharar* were provided explicitly in the Hadith. They include the sale of fish in the sea, birds in the sky, an unborn calf in its mother's womb, a runaway animal, the semen and unfertilized eggs

of camels, un-ripened fruits on the tree, etc. All such cases involve the sale of an item which may or may not exist. In such circumstances, to mention but a few, the fish in the sea may never be caught, the calf may be still-born, and the fruits may never ripen. In all such cases, it is in the best interest of the trading parties to be very specific about what is being sold and for what price. For instance, Ahmad and Ibn Majah narrated on the authority of Abu-Said Al Khudriy:

The Prophet (pbuh) has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.

The last prohibition in this Hadith pertains to a person paying a fixed price for whatever a diver may catch on his next dive. In this case, he does not know what he is paying for. On the other hand, paying a fixed price to hire the diver for a fixed period of time (where whatever he catches belongs to the buyer) is permitted. In this case the object of sale (the diver's labor for – say one hour) is well defined. In many cases, *Gharar* can be eliminated from contracts by carefully stating the object of sale and the price to eliminate unnecessary ambiguities.

In contemporary financial transactions, the two areas where *Gharar* most profoundly affects common practice are insurance and financial derivatives.

Jurists often argue against the financial insurance contract, where premia are paid regularly to the insurance company, and the insured receives compensation for any insured losses in the event of a loss. In this case, the jurists argue that the insured may collect a large sum of money after paying only one monthly premium. On the other hand, the insured may also make many monthly payments without ever collecting any money from the insurance company. Since “insurance” or “security” itself cannot be considered an object of sale (c.f. Al-Zuh. ayli (1997, vol.5, pp.3415-3420), this contract is rendered invalid because of the forbidden *Gharar*. Of course, conventional insurance also suffers from prohibition due to *Riba* since insurance companies tend to invest significant portions of their funds in government bonds which earn them *Riba*.

The other set of relevant contracts which are rendered invalid because of

*Gharar* are forwards, futures, options, and other derivative securities. Forwards and futures involve *Gharar* since the object of the sale may not exist at the time the trade is to be executed. As we are going to see, Islamic Law permits certain exceptions to this rule through the contracts of *salam* and *istisna*. However, the conditions of those contracts make it very clear that contemporary forwards and futures are not permitted under Islamic law.

Classical jurists called such contracts where both the price and the goods were to be delivered at a future date *al-bay al-mud af*, e.g. “I sell you this car for so-much at the beginning of the next month”, and considered them non-concluded and thus invalid. Contemporary options were also discussed by traditional jurists, e.g. “I sell you my house for so-much if my father returns”, and called it a suspended conditional sale (*al-bay‘ al-mu‘allaq*).

They have also rendered such sales invalid due to *Gharar* (c.f. *Al-Gharar wa Atharuhu fi Al-Uqud* by Siddiq Al-Amin (pp.137-149)

## **CHAPTER 4: ISLAMIC BANKING: BRIEF SUMMARY OF THE INDUSTRY:**

### **4.1 Islamic Banking: A Simple Definition:**

The core concept of Islamic banking, also commonly known as interest-free banking, is based on basic ethical standards along with one key difference; Muslims are not allowed to pay or receive interest. Business activities are encouraged as well as making profit, however, Muslims cannot participate in any activities involving interest in any shape or form. As such, financial instruments have been developed by Islamic financial institutions to satisfy these requirements. For example, instead of debt financing, equity financing is used. Instead of borrowing to finance the purchase of equipment, leasing tools were developed. Instead of a fixed interest rate on a savings account, Islamic banks offer a share of the banks profit as a return on deposits (which have been around 5% annually) or place funds in short-term commodities trading accounts.

### **4.2 Brief History:**

Islamic banking, as an institution, has only been around for 25 years but that is not to say that interest-free banks have not been tried before. There was one in Malaysia in the mid forties and another in Pakistan in the late-fifties, neither survived. In 1962 the Malaysian government set up the “Pilgrim’s Management Fund” to help prospective pilgrims to save and profit. The savings bank established in 1963 at Mit-Ghamr in Egypt was very popular and prospered initially and then closed down for various reasons. However, this experiment led to the creation of the Nasser Social Bank in 1972. Though the bank is still active, its objectives are more social than commercial.

The early seventies, on the other hand, saw the institutional involvement. Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, First International Conference on Islamic Economics in Mecca in 1976, International Economic Conference in London in 1977 were the result of such involvement. The involvement of institutions and governments led to the application of

theory to practice and resulted in the establishment of the first interest free banks. The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process.

The first private interest-free bank, the Dubai Islamic Bank, was also set up in 1975 by a group of businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt and Sudan. In the same year the Kuwaiti government set up Kuwait Finance House. Twenty-five years since the establishment of the first Islamic bank, more than 150 Islamic financial institutions have come into being<sup>3</sup>. Though many are in Muslim countries, there are some in Western Europe as well as North American and Asia.

#### **4.3 What's behind today's interest in Islamic Banking?**

As economies of Muslim countries became richer (i.e. the Persian Gulf countries) along with the migration of educated Muslims to western countries, Muslims' interest in their faith grew. Today, the Islamic banking system manages over \$100 billion and is said to be growing at 12%-15% annually<sup>4</sup>. Global financial institutions have recognized this trend and are capitalizing on the attractive niche market. Some of the western banks that have established dedicated Islamic banking subsidiaries or have substantial dealings in the field include, Citibank, Bank of America, Commerzbank, Deutsche Bank, Merrill Lynch, ABN AMRO, BNP Paribas, Pictet & Cie, UBS, Standard Chartered, Barclays, HSBC, Royal Bank of Canada and Brown Brothers Harriman.

#### **4.4 Demand for Islamic Banking Services:**

Islamic banks have come along way in a relatively short time and have captured a significant market share from their conventional rivals. Penetration rates of Islamic banking services in Muslim countries range from 5% in Malaysia to 12% in Saudi Arabia to 30% in Kuwait<sup>5</sup>. It is anticipated that the Islamic banking industry will be responsible for managing at least 40-50% of the total savings of Muslims worldwide in 8 to 10 years. It is important to note that Islamic banks tend to focus on their local markets while western institutions such as Merrill Lynch target the high-net-worth segment. There are no real global players in the field. There are no retail Islamic banks in OECD countries.

Also, Islamic banks do not have the in-house expertise to develop Sharia compliant products and thus, seek financial engineering expertise from western institutions.

#### **4.5 Types of Products and Services Offered by an Islamic Bank:**

Generally speaking, all Islamic banks agree on the basic principles. However, individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. The following will describe the salient features common to all banks.

##### **1. Deposit accounts**

All the Islamic banks have three kinds of deposit accounts: current, savings and investment.

###### **- Current accounts**

Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.

###### **- Savings accounts**

Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands.

###### **- Investment accounts**

Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed. Some Islamic banks structure these accounts to act like a Certificate of

Deposit (CD) where funds are lock in for a period of time and profits are paid out at maturity.

## **2. Modes of financing**

Banks adopt several modes of acquiring assets or financing projects, but they can be broadly categorized into three areas: investment, trade and lending.

### **- Investment financing**

This is done in three main ways:

**a) *Musharaka (venture/equity financing)*** where a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profits and losses are shared in a pre-arranged fashion. The venture is an independent legal entity and the bank may withdraw gradually after an initial period.

**b) *Mudarabha (trust financing)*** where the bank contributes the finance and the client provides the expertise, management and labor. Profits are shared by both the partners in a pre-arranged proportion, but when a loss occurs the total loss is borne by the bank. This type of contract is also used in **fund management** where the fund manager is the *mudarib* who is entrusted to manage clients' money.

**c) *Financing on the basis of an estimated rate of return.*** Under this scheme, the bank estimates the expected rate of return on the specific project it is asked to finance and provides financing on the understanding that at least that rate is payable to the bank. If the project ends up in a profit more than the estimated rate the excess goes to the client. If the profit is less than the estimate the bank will accept the lower rate. In case a loss is suffered the bank will take a share in it. A good example to highlight this, though they do not act exactly the same, is corporate bonds. The investor receives a fixed rate of return. If the company makes more money the bondholder still receives the same amount, however, if the company runs into financial trouble, the bondholder will share in the loss.

### **- Trade financing**

This is also done in several ways. The main ones are:

**a) *Murabaha (Cost-Plus Financing)*** a contract of sale between the bank and its client for the sale of goods at a price plus an agreed profit margin for the bank. The contract

involves the purchase of goods by the bank, which then sells them to the client at an agreed mark-up. Repayment is usually in installment. This type of financing is very commonly used for various installment related financing needs. For example: a customer wants to finance a car purchase for \$10,000 but cannot afford to pay the full amount now. The bank buys the car on the customer's behalf and then sells it to the customer for \$15,000. The bank charges a mark-up because it is willing to accept installments (i.e. over 60 months) instead of one lump sum payment. The mark-up is profit since the bank acted as a middleman; no money was lent, a product was bought and sold. If the customer decides to pay off the entire amount next month or at the end of the 60th month he will still owe the same amount.

**b)** Leasing where the bank buys an item for a client and leases it to him for an agreed period and at the end of that period the lessee pays the balance on the price agreed at the beginning and becomes the owner of the item. Several US investment banks have expressed interest in securitizing Islamic leases.

**c)** Hire-purchase where the bank buys an item for the client and hires it to him for an agreed rent and period, and at the end of that period the client automatically becomes the owner of the item.

**d)** Sell-and-buy-back where a client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after certain time for an agreed price.

**e)** Letters of credit where the bank guarantees the import of an item using its own funds for a client, on the basis of sharing the profit from the sale of this item or on a mark-up basis.

### **- Lending**

Main forms of Lending are:

a) Loans with a service charge where the bank lends money without interest but they cover their expenses by levying a service charge. This charge may be subject to a maximum set by the authorities.

b) No-cost loans where each bank is expected to set aside a part of their funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers.

c) Overdrafts also are to be provided, subject to a certain maximum, free of charge or for a small fee. It is important to note that Islamic banks are not active in lending, as defined by a conventional bank, due its nature of being interest-based. What lending forms were mentioned above are not a complete list of the various modes of the lending.

However, the point being made is that lending in an Islamically acceptable form is not very profitable to the bank, so they must resort to other “lending” related practices, such as leasing and mark-up transactions (a.k.a. *Murabaha*). Islamic bonds, where the rate of return is fixed but not guaranteed, are increasingly becoming popular as financial engineers continue to develop acceptable non-interest related products. Malaysia and Bahrain are currently developing a global Islamic bond market.

### **3. Services**

Other banking services such as money transfers, bill collections, trade in foreign currencies at spot rate etc. where the bank’s own money is not involved are provided on a commission or charges basis.

#### **4.6 Shortcomings in current practices:**

In the previous section the current practices were listed under three categories: deposits, modes of financing (or acquiring assets) and services. There seems to be no problems as far as banking services are concerned. Islamic banks are able to provide nearly all the services that are available in the conventional banks. The only exception seems to be in the case of letters of credit where there is a possibility for interest involvement. However, some solutions have been found for this problem -- mainly by having excess liquidity

with the foreign bank. On the deposit side, judging by the volume of deposits both in the countries where both systems are available and in countries where law prohibits any dealing in interest, the non-payment of interest on deposit accounts seems to be no serious problem. Customers still seem to deposit their money with Islamic banks.

#### **4.7 Islamic banking in non-Muslim countries:**

The modern commercial banking system in nearly all countries of the world is mainly evolved from and modeled on the practices in Europe, especially that in the United Kingdom. The philosophical root of this system revolves around the basic principles of capital certainty for depositors and certainty as to the rate of return on deposits. In order to enforce these principles for the sake of the depositors and to ensure the smooth functioning of the banking system, Central Banks have been vested with powers of supervision and control. All banks have to submit to the Central Bank rules. Islamic banks which wish to operate in non-Muslim countries have some difficulties in complying with these rules. These issues are highlighted below.

#### **4.8 Certainty of capital and return:**

While the conventional banks guarantee the capital and rate of return, the Islamic banking system, working on the principle of profit and loss sharing, cannot, by definition, guarantee any fixed rate of return on deposits. Thus the basic difference lies in the very roots of the two systems. Consequently countries working under conventional laws are unable to grant permission to institutions which wish to operate under the Profit-and-Loss scheme to function as a commercial bank. Two official comments, one from the UK and the other from the US suffice to illustrate this.

Sir Leigh Pemberton, the Governor of the Bank of England, told the Arab Bankers'

Association in London in 1984 that:

- It is important not to risk misleading and confusing the general public by allowing two essentially different banking systems to operate in parallel;
- A central feature of the banking system of the United Kingdom as enshrined in the legal framework is capital certainty for depositors. It is the most important

feature which distinguished the banking sector from the other segments of the financial system;

- Islamic banking is a perfectly acceptable mode of financing but it does not fall within the definition of what constitutes banking in the UK;
- The Bank of England is not legally able to authorize under the Banking Act, an institution which does not take deposits as defined under that Act;
- The Islamic facilities might be provided within other areas of the financial system without using a banking name.

In the United States, Mr. Charles Schotte, the US Treasury Department specialist in regulatory issues has remarked in 1985:

*“There has never been an application for an Islamic establishment to set up either as a bank or as anything else. So there is no precedent to guide us. Any institution that wishes to use the word bank in its title has to guarantee at least a zero rate of interest -- and even that might contravene Islamic laws.”*

Note that these comments were made in the eighties when Islamic banking was still a mystery to most central bankers. Today, the Federal Reserve in the US and the Bank of England seem more receptive to Islamic banking practices as they have seen its market acceptance and growth.

#### **4.9 Tax regulations:**

Another important consideration is the tax procedures in non-Muslim countries. While interest is a ‘passive’ income, profit is an earned income which is treated differently. In addition, in trade financing there are title transfers twice -- once from seller to bank and then from bank to buyer -- and therefore twice taxed on this account decreasing the profitability of the venture. The Director of the International Islamic Bank of Denmark said that tax laws pose the greatest difficulty for Islamic banks in most OECD countries.

## **CHAPTER 5: FINDINGS:**

Islamic finance in general and Islamic banking in particular, is going through the development phase. Based on the guidelines provided by the Shariah, new products are being added into the large number of existing products. New areas are being covered by Islamic Finance and the market available for these products has shown tremendous growth in the past few decades. This market is still underserved and a lot needs to be done to come up with the same range of products and services that one can find in a conventional banking setup. After the September 11 attacks on the U.S, Western banks, whether due to a lack of understanding or unwillingness to be associated with the Muslim world, have been distracted from this market, creating a niche for new comers. As Muslims constitute up to 20 percent of the world's population, an untapped market of such size is music to the ears of financial firms who are eagerly eyeing growth pockets. Among those who offer Islamic services, Citigroup has Citi Islamic Investment Bank in Bahrain, while HSBC operates in Dubai via its Amanah Finance Co. People are now beginning to recognize the interest in the Arab world in investing through Islamic modes of investment. There is believed to be around \$100 billion invested in Islamic funds, and perhaps that's only the tip of the ice berg. Islamic fund management was boosted by the issuance of a fatwa, or religious ruling, in the mid-1990s that investment in modern-day equities did not violate sharia principles.

In the following I will discuss few of the emerging concepts being developed in compliance with the Shariah laws and their impact on the overall direction of Islamic Banking and Finance.

### **5.1 Time as an element in loans:**

#### **5.1.1 Definition, Conditions and Provisions of Loans:**

A loan or *qard* is the transfer of ownership of fungible goods (i.e. goods that may be measured in terms of weight, measure or number) whose equivalent is to be returned without any premium. Loan is an act of charity. Contiguous to "loan" is the "*ariya*" or "loan for use". *Ariya* is the transfer of the usufruct of an asset which should be returned in itself whereas in a loan the equivalent is returned. This means that a loan is a temporary

donation of an asset while *ariya* is a donation of the usufruct of an asset. A loan is concluded by mutual agreement, one party making a proposal (*ijab*) and another accepting it (*qaboul*).

The following conditions should be observed:

1. The lender should be qualified to make the donation;
2. The object of the loan should be a fungible good such as currencies or goods susceptible to measure or weight or goods that can be counted and their units are approximately equivalent;
3. The loan should be received by the borrower;
4. The loan should not entail a benefit to the lender, whether stipulated in the contract or agreed upon verbally by the parties; and
5. The loan should not be tied to a sale transaction or anything else.

The general ruling on loans is that they are permissible, for a loan is a "a good act whether it is to be paid any moment or deferred to a due date".<sup>i</sup>

### **5.1.2 Nature of Time Delay in Loans:**

A condition of credit and *salam* sales is that deferment should be for a well-defined time period. Knowledge of time is required in order to avoid the lack of knowledge to prevent delivery.

The stipulation of a term in a loan, however, is not subject to the same consensus. Two views prevail among jurists, with the consensus that stipulating a term is not necessary for the validity of a loan. Whether the term is provided for in the contract or stated later, the lender is not bound by such term and he may claim the equivalent anytime he wishes. In *Al-Moghni* it is mentioned that the lender may call the loan (its equivalent) at once and that even if term is mentioned in the loan contract, it is not deferrable because deferment requires compensation and a repayment of a loan can neither be increased over nor decreased below the loan itself. Deferment in loan in fact is merely a donation and a promise and it is not, therefore, obligatory to observe it.<sup>ii</sup> Similar views appear in

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<sup>i</sup> Ibn Jizzi, *Al-Qawaneen Al-Fiqhiyyah*, p. 217.

<sup>ii</sup> Ibn Qudama, *Almoghni and Al-Sharh Al-Kabeer* (in one book), Vol. IV, pp. 357-359.

*Takmelatul Majmoub*, an authoritative work on Shafe'i school of jurisprudence. According to Ahmad, the equivalent of the loan is immediately established as an obligation on the borrower even if provision is made for deferment, because this deferment is only a non-obligatory pledge. The same applies to the time-term provision after a contract is made: such a term is not binding. Malek, on the other hand, disputes this consensus view. To him, if a term is stipulated in the loan contract or if it is customary, it becomes obligatory on the borrower to repay it at the due date whether he has benefitted from it or not. If no such term has been fixed and the custom does not imply it, the borrower is allowed to keep it until such time as he makes use of it, as generally accepted for articles of the kind. Ibn Hazm, the Zaheri scholar, agrees with Malek that the deferment of a loan to a certain time is a valid clause if stipulated. He disagrees with Malek, however, in case such clause is not stipulated and the lender calls up his loan. He rules that the borrower can not wait for the time needed to make normal use of the loan.

To Ibn El-Qayyim, if the lender advances a loan and defers the repayment to a fixed date then deferment is obligatory, according to the stronger position in the views of Malek and a version of Ahmad's views. Ibn Hajar says that Ibn Omar, Atta'a, Amr Ibn Dinar and Al-Bokhari are among those who allowed fixing a term to a loan.

The consensus view that loan may be called anytime is based on the assumption that it represents a benevolent contract while sale and *salam* contracts represent exchange of counter values. Thus, the binding nature of the term in credit sales and *salam* is associated with the possibility of raising the price while the absence of such a binding term in loans is associated with the condition that the lender should not derive any advantage from the loan. Malek, on the other hand, bases his position on two pieces of evidence, one from the Qur'an, and the other from Sunna (the Prophet's tradition). His Qur'anic evidence is the verse: "You who believe, when you contract a debt for a fixed term, record it in writing" (II, 285). Malek interprets the verse to mean that the "fixed term" is permissible in all debts, without distinction between loans and other debts. Al-Shafii, however, retorts by saying that the verse does not mean that a "fixed term" is permissible but it only establishes the need for witnesses and writing in deferred debts.

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Malek's evidence from Sunna is the Prophet's saying: "Muslims are bound by their terms (terms agreed upon among themselves)". (Reported by Abu Dawood, Al-Termezi and Al-Daraqutni).

Although most jurists agree that a loan may be called up anytime, omission of stipulating a fixed term may constrain or embarrass the borrower if he enters into financial obligations during the term of the loan, such as buying a house or furniture. This would contradict the feature of good-doing and charity which characterizes a loan. This, however, may be countered by the argument that a borrower is required to repay a loan only if he has the means to do so; and if he is insolvent it is the duty of the creditor to allow him the time to repay. The answer is that insolvency that calls for waiting is the lack of any surplus over basic needs whether in cash or in other assets. Thus, if someone borrows money for a fixed term and uses the loan to buy furniture but the creditor calls up his loan immediately thereafter, the borrower will be forced to sell this furniture, perhaps at a loss.

### **5.1.3 Provision of Non-Profitability of Loans:**

The prevalent rule in this respect is that any loan that entails a benefit to the lender constitutes *riba*. The clearest form of such benefit is raising the amount or the quality of the principal in repayment. If such increase is provided for in the contract that becomes *riba* beyond any doubt.

The benefit drawn from the loan by the lender may take other forms, such as asking the borrower to allow him to live in the borrower's house, to lend him his means of transportation or to offer him a gift. Banning such forms of benefit is to pre-empt the possibility of *riba*.

Today, most loans are in the form of money, and increase in this case is called, in the banking terminology, "interest". Thus, we shall focus in the following paragraphs on the ban on interest and the relation of this ban to time.

### **5.1.4 Rationale of Banning Interest:**

Many contemporary writers and researchers have pointed out that the increase in the amount of cash loans, practiced on a wide scale these days, constitutes *riba*. It is in fact

the stark *riba* banned in the Qur'an, whether the loans are for consumption or for production purposes, and whether the increase is slight or large.

Having learnt that interest is banned by the Qur'anic text, the rationale or the wisdom for such a ban is known to God the Almighty, and we only apply our minds to deduce this rationale and at the same time acknowledge that our deduction may be right or wrong.

An often-cited reason for this ban is to forestall injustice, since increasing the amount is in return of the time-term. Time-term, however, is not an asset to be considered as one's property, and the increase, or interest, is unjustified. There is an agreement without dissent that any increase over the principal amount of the loan is unjust, the evidence being the words of God the Almighty addressing the believers. Having ordered them to "give up what remains of *riba*" and warning them of war from God and his Messenger if they do not, the Qur'anic verse adds: "and if you repent then you have your principal (without interest). Wrong not and you shall not be wronged" (II/279). The question is: does wrong, or injustice arises of the fact that the increase, or interest, is unjustifiable, or does it arise from something else?

Time has an economic value, since an asset in hand is preferable to one on loan, and an immediate payment is better than a deferred payment. A seller takes this economic value into consideration when fixing the price in on-credit sales.

The same principle - that the immediate is better than the deferred - is true in loans. Indeed, if the loaned money was equal in value to the repaid equivalent, there would be no sense in calling a loan a benevolent contract. What the creditor "donates" or gives as charity is in fact nothing but the difference of the economic values attached to the immediately delivered loan and the deferred repayment after a period of time. It is not true, therefore, to say that interest on loans has no counter value, but we hasten to add, that it is usury without any doubt, and, consequently, it is wrong or unjust. Injustice or wrong consists in fact in the unbalanced equation: the increase or interest, on one hand, and the opportunity cost, on the other. The increase over the principal, the common form of which is the bank interest, is certain and its amount is known whereas the yield resulting from investing the loan by the creditor is not sure to materialize and if it does, its amount is not ascertainable in advance. This variance in certitude between the two

counter- values, the interest on one hand and the opportunity cost on the other hand, constitutes the essence of the injustice of imposing interest on loans.

This view has been propounded by Fakhruddin Al-Razi in his exegesis of the Qur'an. Commenting on the Qur'anic verses dealing with *riba* in Sura II, he says: "Why cannot we say that the retention of the capital in his hand (the borrower's) for a long time compensates for the increase (interest), since retention of this money by the lender for that period of time may have allowed him to invest it in trading and making a profit, and when he gives the money to the borrower he may fairly expect the increase to compensate for this alternative opportunity? The answer is that such a profit is only hypothetical; it may not materialize whereas taking the interest (increase) is certain. To take the "certain" as a compensation for the "uncertain" involves some harm".

A question may then arise: but is not this unbalanced equation applicable also in trading on credit? The answer is that such a sale does not involve a contract or agreement to pay an equivalent to time as in the case of a loan. It is rather a contract to sell a commodity where time is observed as a factor in fixing the price. In other words, time in such a sale is dependent on the commodity and its presence contributes to the determination of the price, but is not, in itself paid for. The equation in such a sale consists of a commodity tied to a time-frame and a price which includes an element to compensate for time. Such an equation cannot be perceived as unjust, if the sale is concluded by mutual consent.

#### **5.1.5 Implicit Concept of Time in Loans:**

Lending means ceding uncertain benefit which the creditor would have obtained had he kept his money; borrowing is obtaining benefit which would have been impossible to obtain had the creditor kept his money.

Does banning interest on loans constitute, then, a negation of the value of such benefit?

It should be noted, at the outset, that negation of the value of time in a loan, if established, only relates to the worldly economic value but the creditor in any case, may expect to receive his reward from God the Almighty if he only seeks God's favor. The reward may be deferred to the Hereafter, or may be partly received in this life.

Having made the above remark we may now try to answer the question in both cases of tying the loan to a time-frame or making it payable on demand.

If we consider that a loan is callable (payable anytime), then the benefits of the loan to the borrower are realizable as long as the money remains under his control. If the creditor, however, calls up his money before the agreed term, the debtor may suffer a loss as indicated above. This loss may be more or less than the benefits he draws from the loan before he is asked to repay it. This is as far as the borrower is concerned.

As for the creditor, his loss of the benefits of the loaned money may be incurred in one of two cases:

- a) that at the time of advancing the loan he may have a profitable opportunity to invest his money, or
- b) he may not have such an opportunity at that moment but when such an opportunity arises, he finds the borrower insolvent and the creditor is thus unable to recover his money.

Naturally, if the creditor does not have an opportunity to invest his money at the time of advancing the loan or when he has such opportunity he finds the debtor solvent, then he (the creditor) loses nothing by advancing the loan. The loan in this case becomes a temporary allocation of an invested money to an act of charity and kindness which brings him divine reward. Since the creditor does not know in advance whether the debtor will be (later) insolvent or not, he will always be exposed to lose the potential benefit of the money he loaned, and consequently, stipulating that the loan be repayable anytime is not inconsistent with the fact that banning interest amounts to a loss of the economic value of the potential benefits ceded by the creditor.

If, on the contrary, we consider that fixing a binding term in the loan is allowed, the borrower will certainly enjoy the benefits of the loan whereas the creditor will lose the benefits of liquidity during the loan term and the likely profit of any profitable transaction that may arise during the same period. In this case, failing to compensate the creditor would entail for the lender a loss of economic value of the potential benefits during the period of the loan.

It is interesting to note that the outcome is the same in both cases. In the first, the loan cannot constitute an acceptable mode of financing because the trader or manufacturer needs, more than anybody else, to ensure himself against surprises in the conduct of his

business. It is inconceivable that he would finance his economic activity through borrowing knowing that he may be required to repay the loan at any moment.

In the second case, keeping money idle for long or short periods of time for no return may lead money-owners to be more wary of lending their money, especially when the need of the borrower is not acute. Thus, in both cases a loan would become a means to satisfy the needs of the needy. In other words, it would not be possible to use it as a means to finance trade, industry or agriculture.

Whether a loan is payable on demand or deferred to a fixed term, the most important effect of loans would perhaps manifest itself in the curtailment of the economic role of loans to the benefit of other means of financing economic activity such as *mudarabah*, "partnership" or others. An interest free loan (*qard hassan*) would become only a means of social solidarity, and this marginal role is in sharp contrast to the pivotal role of loans in the financial system based on "interest".

To grasp this all important difference in the roles of loan in both systems on the macro-economic level, we need to recall the adverse effect of money-lending mechanism on economic stability.

Trading in money, which is the core of lending with interest, leads to expanding credits beyond the needs of those dealing in goods and services. As a result, a discrepancy develops between real exchanges and cash flows, which is the essence of instability. Maurice Allais<sup>iii</sup> has estimated that monetary flows among the Group of Seven industrial countries were 34 times more than real flows of goods and services. He attributed this severe imbalance in world economy to the mechanism of credit<sup>iv</sup> which allows expenses and debts to be settled by mere promises of payment without any real counter-part, thus boosting speculation, which means that dealers in markets are able to buy without paying and to sell without acquiring. Such a state of affairs leads to a wild expansion of credits, sharp and frequent fluctuations of exchange rates and a basic

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<sup>iii</sup> A French economist, laureate of the Nobel Memorial Prize in Economics. He made these points in a lecture entitled "The Monetary Conditions of an Economy of Markets: From the Teachings of the Past to the Reforms of Tomorrow" (Under publication), delivered in Jeddah at the invitation of the Islamic Development Bank.

<sup>iv</sup> The objections of Allais to the credit mechanism are not in the absolute. Rather, his objections focus on the workings of this mechanism in capitalist societies at present.

instability in the economy as a whole. By contrast, the Islamic financial system which seems to allow the lending-borrowing mechanism only a marginal place, ties economic credits<sup>v</sup> to real flows of goods and services. Under the Islamic system, debts arise only from the sale of goods on credit, the sale of goods whose delivery is delayed (*salam*) or deferment of rentals which is the sale of usufruct.

This shows that the Islamic *shari'ah*, by banning interest on loans and allowing price increase, actually establishes a financial system where monetary flows and real flows are harmoniously integrated. It thus eliminates the most serious cause of fluctuations and instability.

We may also conclude that interest on loans does not only bring injustice to the individual but also inflicts severe harm on the economy as a whole. Perhaps the rationale, or wisdom, of banning interest is not confined to the elimination of injustice to the individual but goes farther as it eliminates adverse effects on the economy.

## **5.2 Venture Capital Finance:**

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;

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<sup>v</sup> As opposed to social credits which respond to the need for solidarity and charity.

- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards;
- Have a long-term orientation

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. Going forward, they actively work with the company's management by contributing their experience and business savvy gained from helping other companies with similar growth challenges.

Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times they will co-invest with other professional venture capital firms. In addition, many venture partnership will manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of world's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development.

### **5.2.1 Venture Capital and Islamic Finance:**

This paper will not go into the detail steps of venture finance as it assumes the reader to have clear understanding of it. Hence we will only go into the detail of Islamic Venture Capital and how traditional concepts can be incorporate into it.

### **5.2.2 Islamic Venture Finance:**

To explore this topic in detail, there are a few basic questions that need to be answered. First, is venture capital an acceptable investment vehicle for Islamic investors? If so, then the next question would be whether or not the structure mentioned above is Sharia compliant. If not, what structure can be used?

### **5.2.3 Sharia Views on Equities**

Sharia scholars are in agreement that venture financing at the early stages of a company's life is a classic form of *mudaraba* financing, not only because of the relationship between the provider of capital and the user, but also because investors can stipulate how they want their funds used. A *musharaka* structure is another tool which can be used to finance a venture.

To illustrate the acceptance of equity under Sharia let's take a look at the equity fund industry. Prior to 1995 there were only a handful of Islamic equity funds on the market compared to over 100 today. Islamic bankers realized that if they wanted to become a serious alternative to conventional banking, they had to offer similar investment choices as their conventional rivals. In the early nineties, Islamic bankers were set in developing equity funds where Muslim investors are able to participate in the growth of world equity markets. Sharia scholars had the complicated task of setting the parameters by which Muslims can invest. Today, equity funds are a standard product offered by Islamic institutions.

To sum up the Sharia view on equities, the following is a statement issued by a prominent Sharia scholar in the Gulf, "... *If we consider the circumstances of these companies (traded on world stock exchanges), we realize that they constitute an indispensable need in the economic structure of the country, and no state can dispense without them. Moreover, they meet the urgent needs of individuals for investing their savings.*"

### **5.2.4 The Fundamental Sharia Principle of Muamalat:**

This principle, which is clearly defined in jurisprudence, relates to human dealings and contracts along with issues regarding human relations. It simply states that everything is permitted unless clearly prohibited. As such, private equity and venture capital are perfectly acceptable modes of finance and investment provided they meet certain Islamic guidelines. The principle of *Muamalat*, which literally translates into "dealings," should not be confused with the Sharia principle of *Ibadah*, which literally translates into "worship." The principle of *Ibadah* states that everything is prohibited unless permitted and this relates to all issues of worship and not dealings. Thus, trade and business activity are permitted and are actually encouraged. Since trade and business fall under the

principle of *Muamalat*, entry into business dealings are permitted provided that they avoid any prohibited activities, (i.e. pay or receive interest).

### **5.2.5 Structuring Issues:**

Even though investing in a venture is an acceptable financial transaction, some aspects of the structure are not inline with Sharia guidelines. These aspects are mainly related to the structure of preferred stock and shares that act like a debt instruments. A Sharia compliant structure aims to balance the risk/reward benefits to all parties involved in a deal. As such, any financial instrument that acts like a debt security where the investor can get a “riskless” reward is prohibited. However, if the burden of risk is tilted unevenly towards the investor, the investor will lose the incentive to participate in an unexpectedly high-risk venture. What can be done to balance the risk in a Sharia compliant venture? Fortunately, as Islamic banking continues to develop, new and innovative financial instruments are being developed to answer these questions. The following aims to offer solutions to two issues, the first regarding the use of preferred stock and the second regarding the use of a discount rate to arrive at a company’s valuation.

#### **a) Preferred Stock**

In order to minimize the downside risk to Islamic investors, workable Islamic alternative to preferred stock has been suggested, but there is no evidence to see whether or not such an instrument has been used in a venture capital transaction. This “Islamic” preferred stock acts like a pure preference share with predetermined varying profit ratios. There can be no accumulation of profits and no liquidity preference to one investor over another in case of a sale or liquidation. Thus, this is more like common stock with predetermined profit ratios.

#### **b) Valuing Company Using Discount Rate**

Since private equity deals are by nature risky transactions for several reasons, true valuation of the deal is crucial to achieve a target rate of return. Conventionally, discounting rates are benchmarked against some risk free security, such as T-bills.

This is a gray area from an Islamic perspective. However, Islamic investors need not worry about such discount rates since venture capitalist tend to value a company based on (a) returns on a project of a similar risk profile, (b) the average return on a well diversified equity portfolio. This is Sharia compliant.

### **c) A workable Solution under Existing Structures**

Finally, a simple and ready to use solution is available but may not be an optimal solution for some Islamic investors. The solution is to use a combination of vesting and covenants along with the issuance of common stock. Both vesting and covenants can be easily designed for the Islamic venture capitalist and will avoid costly structuring of untested financial instruments. Islamic investors can pool their resources into a venture capital fund to seek out lucrative investments, while at the same time, minimize their risk by spreading it across a diversified investment portfolio of companies.

## **5.3 Islamic Securitization:**

The fact that Islamic institutions have a growing participation in the global securitization business is an affirmation of the success they have achieved during the last three decades. Since securitization is a recent invention in conventional financial practices, it is a considerable achievement for Islamic institutions to be involved with this new dynamic line of business. After all, they were until recently struggling to come up with a replacement for products as mundane as saving accounts. In order to appreciate the importance of securitization to Islamic institutions, one must learn how securitization is commonly understood. Then, it is useful to proceed to highlight the specific concerns of Islamic institutions in the securitization process, and touch upon some limitations of Islamic institutions' practices in securitization. Finally, we will understand the importance and the future of Islamic institutions applying this financial method.

### **5.3.1 Definition:**

In defining securitization we focus on processes - the process of pooling assets, the process of packaging them into securities, and the process of distributing securities to investors. As Islamic institutions are more concerned with the Islamic acceptability of the

securitization business, their focus is more on the content of the "package" rather than the process of packaging. Therefore, they tend to ensure that the assets in the package – and not the package alone - are Islamically acceptable. A more specific definition characterizes securitization as the process of packaging designated pools of assets with or without credit enhancement into securities, and the sale of these securities to the appropriate investors. The process involves the creation of homogenous assets - both in kind and in underwriting criteria - and then pooling them into a significant saleable size. Generally, a pool, on the whole, has a better credit characteristic (through diversification of credit risk, transaction size, geography, etc.) than an individual asset. The process may also involve the provision of additional protection for the investors against late payments, pre-payments, potential write-offs, as well as cash-flow timing mismatches. Such protection is often provided in the form of credit and/or liquidity enhancement schemes, as will be explained later.

### **5.3.2 The Case for Securitization:**

Securitization is an American invention, but no longer remains an American curiosity. Almost all the major financial systems have certain securitization schemes. The sale of whole loans could be dated as far back as the 1880's in the USA. The origins of securitization of assets, however, are traced to the 1970's when the Government National Mortgage Association ("GNMA") developed the GNMA pass-through, a mortgage - backed security collateralized by single-family Federal Housing Administration ("FHA") and Veterans Administration ("VA") mortgage loans. Securitization grew into a significant business in the 1990's. Today, securitized assets not only include mortgages on properties, but also credit card receivables, computer leases, equipment notes financing, auto loans, and even future sales of music records. There was even an attempt to securitize the life insurance policies of people with full-blown AIDS, enabling them to monetize their polices. As one can observe, both Islamically permissible and impermissible assets are routinely securitized in the US and international financial markets.

The growth of securitization is basically driven by four factors; first, the imposition of capital adequacy ratios and reserve requirements on financial institutions by the regulatory agencies have made financial institutions safer place to invest in. But these restrictions have "costs" as they either add direct cost or restrict the ability of these financial institutions to increase their volume of business. Securitization enables these institutions to efficiently remove assets from their balance sheet. It allows them to monetize previously illiquid assets, recycle cash to be reinvested and, hence, expand the volume of their business without a corresponding increase in their equity capital. In simple terms, securitization allows financial institutions to serve more customers without having to raise new funds in the form of either equity or deposits.

Second, whenever the global cost of capital increases, securitization helps financial institutions to raise cheaper capital for their businesses at the asset level instead of the enterprise level.

Third, there is a growing convergence of many capital markets into one, as the barriers between them were removed. As all segments of the economy now compete for the same capital, efficient, low cost of financing have become more necessary.

Fourth, increased ability to generate and utilize information through popular use of rapidly improving computer technology has resulted in significant gains for the securitization business. It is now possible to obtain credit and liquidity information on millions of financial assets, enabling the market players to isolate certain types of assets with the objective of making them self-financing. The availability of information enables institutions to remove certain assets from their balance sheets and obtain better credit than what the originators could command in the market, and, hence, lower cost of funding.

These four trends have helped the growth of global securitization industry since the 1980's. By the end of 1994, the total volume of asset-backed securities issued in the USA and Europe alone exceeded 400 billion US dollars, a significant progress for a line of business that was largely unknown before the 1970s. As of this writing, the asset backed markets have blossomed to \$ ? trillion despite the weak global economy.

The securitization process has also some specific benefits for Islamic institutions. As Islamic finance tends to relate finance to assets, asset backed securitization is the right

product for Islamic institutions, as long as these assets are structured in accordance with Islamic principles. The concept of asset backing is prevalent in all other Islamically-structured transactions. For example, in trade finance we use "morabaha" contract, which enables the Islamic institutions to purchase certain goods and sell the same to a client at a pre-agreed profit margin, rather than giving an interest-bearing loan to the client, which then purchases the goods. In project finance, we prefer to buy equipment and lease it to a project-promoter, instead of providing him with liquid capital against payment of interest. Therefore, the use of securitization will bring in much needed liquidity to these institutions, by enabling Islamic institutions to free part of their capital which is tied-up with these illiquid project and trade financing activities.

### **5.3.3 Word of caution:**

The question, therefore, is not whether Islamic banks should play a role in this dynamic market; it is the "how" which intrigues many market observers. But before we examine the mechanisms to be employed, we should, perhaps, drive home certain realities about Islamic institutions; realities that can sharpen their focus on this line business.

As Muslim-owned banking and non-banking entities, Islamic institutions conduct the major part of their business in the Muslim world. Being a regulation-driven process, securitization, however, is prevalent only in countries with developed regulatory framework i.e., the OECD countries like the United States and United Kingdom and a few emerging economies like Kuwait, Singapore and Malaysia. While Islamic institutions, therefore, can easily securitize the assets they own in the most developed economies, they may not easily do the same with the bulk of their assets in the Muslim world. In addition, the successful use of securitization requires the availability of credit and financial information on the underlying assets, the existence of accounting standards, and the possibility of having some rating systems. None of these conditions are satisfied in most of the Islamic countries. The only exception to this rule is where securitization is employed to raise funds for certain self-contained projects with guarantees from host governments, and with possible backing from international funding organizations, as has been implemented in recent years in countries like Turkey, Pakistan, Malaysia, and Egypt.

In securitizations, we have identified four main issues of concern to Islamic institutions:

- The type of asset must be acceptable to Islamic investors;
- The structures to be used must be acceptable;
- A sufficient element of ownership must be conveyed to comply with Islamic principles governing asset sales and assignments; and
- Any form of credit enhancement must be in a permissible form..

#### **5.3.4 The Assets:**

As securitization is established and developed primarily in non-Islamic economies, the assets typically included in securitized pools do not necessarily conform to Islamic norms. The assets in Western securitized pools are invariably interest-bearing debt instruments, such as credit card receivables, mortgages, etc. As Islam does not permit the use of interest, it is important for Islamic banks to originate their own Islamically acceptable assets, rather than buy pools of assets in the market. They should therefore use securitization as a secondary tool to provide certain efficiencies to their own operations, and not as a primary business for servicing or underwriting transactions for third-party financial institutions and investors, which are probably non-Islamic in their investment practices. The latter course will invariably involve them in benefiting from restructuring non-halal assets into Islamically permissible investments. As Islam does not permit the payment or receipt of interest, the sale or purchase of debt instruments is not permitted

unless this debt is interest-free and is sold on its face value, which is not the most profitable proposition for any organization.

For an Islamic institution, the underlying assets to be securitized will include leasing, equity ownership, and morabaha contracts. As explained earlier, these contracts may mimic financings by trading or leasing assets and are Islamically acceptable. They are also applied to a wide range of industries, For example, leasing could be applied to funding the lease of equipment required by businesses, funding purchase of computer and cars by individuals, and funding the acquisition of homes by individuals, in effect replacing straight mortgages. In the latter case the ownership of the financed house remains with the financier but the house is leased back to the client with an option or a promise to buy out the house from the financier at a predetermined price at some future date. While the leasing law differentiates between operating and financial leases, this distinction is not very pertinent for Islamic scholars, and are all generally considered acceptable. Alternatively in the housing case, an investor could share equity ownership with a consumer in a house, with an agreement for the consumer to buy out the investor's equity stake over a specific term at a mutually agreed price and profit. Similarly, morabaha contract could also be used for all the above, but the unsolved issues, including the Islamic restrictions on trading in debts or managing prepayment risk, may limit its use in securitization, but not syndication.

### **5.3.5 The Structures:**

In a securitization structure, the players include the originators, servicers, issuers, investment bankers, credit enhancers, rating agencies, and trustees. Originators originate the assets, but can also serve as the servicers, which are responsible for the management and maintenance of assets and the related cashflows. Assets are first sold to Issuers, which are bankruptcy-remote Special Purpose Vehicle ("SPV"). The SPV then issues securities, which are claims on the assets held by the issuer. Such claims carry a specific form of attachment to the ownership of the asset. When assets are not sold to an incorporated SPV, they are sold to a trust, which takes the form of either a guarantor trust or an owner trust. Trusts are created and managed by trustees for the benefit of beneficial owners. Investment bankers underwrite the securities for public offering or place them privately to institutional or wealthy investors, while rating agencies provide the necessary

rating, based on certain recommended level of credit enhancement. Finally, the credit enhancers provide the required credit and/or liquidity enhancement, which could be a reserve fund from the asset's cash flow or collateral pledged to support the asset or a guarantee, in order to obtain the required credit rating.

With this background, we may now specify the three main structures commonly used in securitization. The originators choose between three types of structures; pass-throughs asset-backed bonds, and pay-throughs. These structures have been developed in the secondary mortgage and non-mortgage market.

A pass-through represents direct ownership in a portfolio of assets that are usually similar in terms of maturity, yield, and quality. The originator services the portfolio, makes collections, passes them on, less a servicing fee, to the investors. Ownership of the assets in the portfolio lies with the investors; thus, pass-throughs are not debt obligations of the originator and do not appear on the originator's financial statement. Pass-throughs may also be designed to represent an assignment of a portion of ownership, rights and obligations, but not a conveyance of title. Sometimes complex tax or investor issues, and in many Islamic countries, rules restricting foreign ownership of locally domiciled assets require the partial assignment or sale without recordation.

Like the pass-through, the Asset-Backed Bond ("ABB") is collateralized by a portfolio of assets, or sometimes by a portfolio of pass-throughs. The ABB is a debt obligation of the issuer, so the portfolio of assets used as a collateral remains on the issuer's books as assets, and the ABBs are reported as a liability. Also, the cash flows from the collateral are not dedicated to the investors. They are often reconfigured, with the residual often remaining with the issuer/ originator.

One important aspect of the ABBs is that they are over-collateralized, i.e., the value of the underlying assets is significantly in excess of the total obligation. This is largely done in order to provide some level of comfort to the investors.

The pay-through bond, however, combines some of the features of the pass-through with some of those of the asset-backed bond. The bond is collateralized by a pool of assets and appears on the issuer's balance sheet as debt. The cash-flow from the assets, however, are dedicated to servicing the bond in a way similar to the pass-throughs.

In addition to collateralized bonds and pay-through notes, commercial paper and preferred stock were also used in the past as alternative structures.

Of the above widely used securitization structures, the pass-through is perhaps the structure closest to satisfying a strict interpretation of Islamic principles. The pay-through, the ABB and the Commercial Paper are debt- structures, which make explicit use of interest. Therefore, only a pass-through with underlying pool of assets structured as morabaha, equity stakes or ijara, could facilitate Islamic institutions to expand their current activities in the securitization business.

Having said that, it is also possible to use certain variations of a pay-through, which closely resemble the pass-through. We may have a pass-through with certain degree of credit enhancement for the investors as follows;

#### **5.3.6 Ownership Conveyance:**

The structures that we have discussed must, in order to comply with Sharia'a, transfer some minimum level of ownership. This is not necessarily registered title. It could be a rather simple collection of ownership attributes that allow the investor to step into the shoes of the issuer or co-owner and perform duties related to ownership. Likewise, these could also be rights granting access, subject to notice. Such access might result in curing a defect caused by the operator or issuer, or even result in the taking over operations by the investor. Such rights and obligations might ultimately empower the investor to take control of the asset and sell it outright into the market place. As we will see in our examples, the level of conveyance varies for practical reasons and our Scholars have asked us to observe a specific level of conveyance in order to avoid the deconstruction of asset investment into debt sale.

All three structures described above may result in the issuance of a number of documents that flow from lessee or home buyer, that is the recipient of the investment to the investor. These may include promissory notes, mortgages or security instruments, and various documents of conveyance or assignment. Generally, these have no bearing on the Islamic contract, assuming that they do not contradict it. For instance, there is no restriction in Sharia'a to promise to make specific payments as is required by a promissory note. But, there are customary judicial procedures that make it difficult for an investor to act against the holder of an asset if a promissory note does not exist. The same

applies to security documents like chattel liens or mortgages. Even though the investor has some aspect of ownership, in the end customary procedures in many jurisdictions require the investor to hold a right of enforcement like a mortgage in order to secure legal satisfaction in a contentious case.

There is, however, a single dominant Sharia'a rule governing all documents, namely that they are conveyed together. In an interest bearing securitization, two securities might be derived from a single lease – a principal only instrument governed by the contract of lease and any security instrument, and an interest only instrument governed by the promissory note. This practice is not acceptable in Islamic investing, and an assignment of any document, contract, promissory note or security instrument, must be accompanied by all of the documents. In other words, Islamic institutions are not allowed to derive multiple instruments from one in a manner that creates either the sale of a debt, sale of an isolated cash flow, or a direct interest obligation.

### **5.3.7 Credit Enhancement:**

In an effort to obtain best pricing for the securities to be sold by the SPV to the investors, the originator in a traditional securitization chooses to issue two classes of securities, A and B, such that class A gets priority over class B on the payment priority scale. The originator retains security Class B, which is subordinate to class A. In this case, the SPV receives the total cash-flow attributable to both classes of securities and distributes the same in the order of priorities stipulated in the incorporation documents. This is normally done in order to secure a better rating for the Class A certificates, hence better pricing, which is supported by the cushion provided by Class B certificates.

Under Islamic securitization scheme, we can achieve the same objective by assigning the full ownership rights of the total assets in the pool to class A holders, but with a lease back agreement to lease to the issuer the entire portfolio with some fixed rental payments. The issuer also gets an option (or an obligation) to buy back the entire portfolio at pre-determined prices on some future dates. Both the sale price and the rent are prefixed in order to ensure that the holders of class A certificate get a fair market value for the risks they took.

Another form of enhancement is for the issuer and servicer to set aside some of the asset cash flow that was allocated to them. This becomes a first loss pool, a form of self

insurance for the asset pool if you like. In this case, no guarantee, insurance or complicated buy back structure is required. Sometimes this is a very efficient form of enhancement as some rating agencies will dictate the size of the pool based on the past performance of similar assets, and to everyone's surprise the level of funding is not excessive.

Securitization can also involve other types of credit enhancement such as the creation of spread accounts, bank letters of credit, pool insurance, mono-line insurance for up to 100% of the pool size or straight sub-ordination. We have also touched upon the issue of over-collateralization as provided in the pay-through structure.

Islamic institutions should be very selective in using the credit enhancement methods; the use of some of them changes the character of the transaction. For example, the existence of spread accounts for the excess cash implies the transaction was not a pass-through as the originator was able to keep certain undistributed cash over and above what was paid to the investors and administrators. The investors themselves can, however, willingly deduct part of their income in a reserve account, which is perhaps managed by the investors, to meet eventual losses, if any.

Likewise, the investors may also buy pool insurance, obtain a letter of credit, or blanket the pool with a mono-line insurance. There is nothing wrong with the use of these products as long as the investors are willing to buy them and have the choice to use or not to use them. Likewise, it is possible for the Islamic investors to use certain liquidity facility to cover any possible temporary shortfalls, due to mismatches in cash-flow timing, etc., as long as these facilities are arranged on terms acceptable to Islamic practices.

## **5.4 Central Bank in Islamic Financial System:**

### **5.4.1 Introduction:**

The central bank has the sole authority to issue money (currency) and the responsibility to regulate the banking system in order to secure the value of money and realize the other objectives of monetary policy. Money serves as the medium of exchange and the commonly accepted means of payment, and as such as a measure of value. Excessive fluctuations in the value of money lead to economic distortions and causes social

inequities. Inflation gives windfall gains to the rich and the business people but causes hardship to the fixed and low-income groups by eroding their purchasing power. Worse still, deflation often deprives the latter of their employment and means of livelihood. The phenomena of inflation and deflation are characteristic of the financial system based on the institution of interest, which is prohibited in Islam.

#### **5.4.2 Objectives of monetary policy in Islam:**

Consistent with the Islamic ideals of social justice, equity, fairness and balance, there are three major objectives of monetary policy in an Islamic economy, which discards interest. These objectives are:

1. Stability in the value of money;
2. Economic well-being with full employment and optimum rate of economic growth; and
3. Distributive justice.

For a proper appreciation of the above-mentioned objectives of monetary policy and how these may be realized, they are explained below.

#### **5.4.3 Stability in the value of money:**

In an Islamic economy it is almost mandatory on the central bank to preserve the value of money. Thus the central bank should allow expansion of money supply to the extent it is justified by a possible contribution to growth in real balances. The stability in the value of money should be accorded high priority because of the unequivocal stress of Islam on honesty and fairness in all human dealings, and because of the negative impact of inflation on socio-economic justice and general welfare. But, rather than absolute, this objective would mean relative stability in the general price level. Absolute price stability is neither feasible nor desirable as it may conflict with the optimum growth and full employment objective of the monetary policy.

#### **5.4.4 Economic Growth and Employment:**

While inflation is incompatible with the goals of an Islamic economy, prolonged recession and unemployment that cause human sufferings are also unacceptable. Monetary policy has, therefore, to aim at a high rate of economic growth with full employment and utilization of productive resources. However, maximization of economic growth *per se* and at all costs is not the objective of monetary policy in an Islamic economy. Material prosperity is to be attained within the framework of Islamic values. It should not be attained through the production of essential and morally - questionable goods and services. It should not lead to an excessive and overly-rapid use of Allah-given resources at the expense of future generations, and it should not be harmful to present or future generations by degenerating the moral and physical environment. Environmental degeneration with degradation and depletion of land, water and forest resources and serious air and water pollution are already matters of great concern around the world. Hence the concept of "sustainable development", which means meeting the needs of the present generation without compromising the needs of future generations. Economic development and sound environmental management are complementary aspects of the same agenda. Without adequate environmental protection, development will be undermined; without development, environmental protection will fail.

#### **5.4.5 Distributive Justice:**

Monetary policy should be used actively to promote the goal of distributive justice and prevent concentration of wealth and economic power in an Islamic economy. However, too much concern with distributive justice in formulating and implementing monetary policy may adversely affect its overall efficiency and effectiveness in attaining the other goals of monetary policy. e.g. growth, employment and development. Reduction in income inequalities and necessary redistribution should be an important policy objective of an Islamic state and hence the domain, mainly, of its fiscal policy. Monetary policy can contribute to this objective.

## **5.4.6 Functions of the Central Bank:**

### **1: Pivot of the Islamic banking System:**

The central bank should be the pivot of the Islamic Banking System, because only through its conscientious and creative efforts and eternal vigilance can the Islamic money and banking system function properly and achieve its objectives. It should be an autonomous government institution responsible for the realization of the socio-economic goals of the Islamic economy in the sphere of money and banking.

### **2: Issue of Currency:**

Like all central banks, the central bank in an Islamic economy should be responsible for the issue of currency and, in coordination with the government, for its internal and external stability. It should act as banker to the government and the member banks. It should make arrangements for clearance and settlement of checks and for transfers, and should act as the lender of last resort. It should guide, supervise and regulate the commercial banks, the non-bank and specialized financial institutions, without unduly affecting their autonomy. Unlike the conventional central bank, it should also bear the responsibility of preventing the concentration of wealth and power through the financial institutions.

### **3: Stabilization of the Value of Money:**

Stabilization of the real value of money should be an important function of the central bank in order to realize the healthy sustainable growth of the Islamic economy and to ensure socio-economic justice. For this purpose, it would have to keep a close watch on money supply, to ensure that the growth in money is not out of step with that in real output. This does not imply that the money supply is the only variable influencing prices. All it implies is that the *money supply matters*, and that without its proper regulation one of the important instruments for realizing the economic goals of Islam will have been blunted.

#### **4: Implementation of Monetary Policy:**

The central bank should be the primary institution responsible for implementing the country's monetary policy. For this purpose, it should use the instruments and methods that are not in conflict with the teachings of the Islamic *Shariah*. Further, since the central bank cannot realize the goal of monetary stability without cooperation from the government, a harmonious fiscal - budgetary policy would be indispensable.

#### **5: Promotion, Regulation and Supervision:**

The central bank will also have to play a positive role in the promotion, regulation and supervision of all financial institutions with the objective of helping them and making them healthy and strong. For this purpose it may have to review all existing laws and amend or reconstitute them in the light of Islamic teachings. The reformed banking legislation should reflect the different needs of the Islamic financial system.

#### **6: Ensure health and Development of Public Interest:**

The central bank should not confine its regulatory role merely to the commercial banks. Its vigilance and assistance must envelop all other financial institutions to ensure their health and development and to safeguard the public interest. If some other government agencies are responsible for promoting and regulating non-bank financial and auxiliary institutions, then there should be proper coordination between the Central bank and other regulatory authorities to bring on harmony in their promotional and regulatory functions.

#### **7: Lender of the Last Resort:**

As in conventional banking, the Islamic central bank would also have to act as the lender of last resort to ensure sufficient liquidity and to sustain the banks in case of liquidity or solvency crisis. Its ingenuity would be reflected in the way it handled crisis situations without bailing out bank management and yet safeguarding the interest of depositors and equity-holders who are not a part of the management. Temporary accommodation from the central bank provides the borrowing bank with a brief respite and enables it to survive

until remedial measures are enforced and become effective. This is necessary for maintaining confidence in the banking system.

#### **8: Financial Assistance by the Central Banks:**

The central bank, to help any Islamic bank tide over its temporary liquidity problem, may provide general accommodation in the form of *Mudaraba* deposit on which the Islamic bank may pay profit at the rate declared on such deposits.

The central bank may also provide refinance to Islamic banks against finance provided by them for purposes, projects or sectors specified by the central bank. Such refinance may be provided under *Mudaraba*, *Musharaka* or any other Islamic mode of finance.

#### **9: Current Account and Clearing House Facility:**

Islamic banks may be allowed to maintain current accounts with the central bank and to participate in the bank's clearing house operations. If the current account is occasionally overdrawn, the central bank may provide this facility without any charge. Alternatively, such facility may be extended on the basis of sharing of the profits of the bank.

#### **10: Regulation and Supervision of Islamic Banks:**

Islamic banks may be subjected to regulations and controls by the Central bank in respect of (a) permission to establish banks and to open new branches; (b) minimum share capital; (c) the terms governing the constitution of Boards of Directors and appointment of Chief Executives and auditors; (d) tariffs for banking services; (e) measures regulating foreign exchange transactions; (f) submission of periodical statements and operational data to the central bank and (g) Compliance with the working hours.

#### **11: Inspection of Islamic Banks:**

Islamic banks may be subjected to periodic inspection by the central bank to ensure their operational soundness. The central bank personnel may be adequately trained in *Shariah*-based operations of Islamic Banks. Detailed guidelines for inspection of the Islamic

banks should be prepared and set by the central bank, as it should carry out research and training of personnel.

Bank supervision and inspection would be more important in an Islamic system. Unlike the examination of conventional banks, it may be necessary to ensure that, in addition to proper documentation, the projects financed dare sound. To examine all projects financed by the banks would be difficult. It should, however, be possible to examine a random sample of projects financed to ensure that banks do not indulge in financing speculative or unduly risky ventures. Supervision should not be concerned solely with individual banks. It should acquire an operational importance and should aim at promoting the efficiency and stability of the whole financial system, by means of action directed towards both the system itself and individual components, without interfering in moral operational decisions. Moreover, supervision presupposes adequate disclosure and accurate information, and proper auditing. The central bank should play an important role in determining the requirements for this purpose. It should try to strengthen internal controls and issue policy guidelines, and monitor the quality of assets and operations. It should reform the concepts and procedures of auditing to ensure soundness and honesty.

#### **5.4.7 Sources of monetary expansion:**

To ensure that growth of money supply is adequate and not excessive, it would be necessary and important to monitor carefully all three of the major sources of monetary expansion. The two domestic sources are: i) Financing of government fiscal/budgetary deficits by borrowing from the Central bank; and ii) Expansion of deposits through commercial bank credit creation. The third source of monetary growth is external and is monetization of a balance of payments surplus.

**i) Fiscal Deficits** - Fiscal deficits can be, and have been, an important source of excessive monetary expansion. Attempts by the government to extract real resources at a faster rate than is sustainable at a stable price level could lead to continually rising fiscal deficits and accelerated increases in money supply, thus contributing to an inflationary spiral. This has tended to shift a disproportionate burden of the fight against inflation onto the monetary policy. According to one important study, "*the greater the dependence of the*

*public sector on the banking system, the harder it is for the central bank to pursue a consistent monetary policy".* Hence for the monetary policy to be effective, there must be coordination between monetary and fiscal policies for the realization of national goals. This under scores the need for a realistic and non-inflationary fiscal policy in a Muslim country. This does not necessarily rule out fiscal deficits but imposes the constraint that deficits be allowed only to the extent necessary to achieve sustainable long-run growth and broad-based well-being within the framework of stable prices.

The need to eliminate unproductive and wasteful spending is a religious imperative for all Muslims. It is particularly important for governments because they use resources provided by the people as a trust, and using these wastefully or unproductively is a breach of this trust. The limited resources must be used efficiently and effectively with the acute consciousness of accountability to Allah. It requires a careful review of the entire expenditure program in the light of Islamic teachings.

After all the wasteful and unnecessary spending has been eliminated, the balance of government spending may be divided into three parts:

1. normal recurring expenditures
2. project expenditures
3. emergency expenditures

All normal, recurring government expenditures, including outlays on projects not amenable to profit-and-loss sharing arrangements, must be financed by tax revenues. The non-availability of debt financing for such purposes should prove to be a hidden blessing and help introduce the needed discipline in government spending. The government may undertake projects, which are amenable to equity financing, where this is necessary in the public interest, but the financing should be obtained by selling shares to financial institutions and the public. A commercially oriented pricing system should be adopted without a general subsidy. All subsidies needed for the poor and lower middle class families should be arranged from *Zakat* revenues, donations or *Qard Hasan*. Equity financing and commercial pricing should help eliminate some of the unnecessary and

unproductive or prestigious projects that governments sometimes undertake to satisfy vested interests. Emergency expenses or unavoidable deficits, which cannot be financed by either of the two ways may be financed by borrowing from the banking system within a non-inflationary framework and to a limited extent.

**ii) Commercial Bank Credit Creation:** Commercial bank deposits constitute a significant part of money supply. These deposits may, for the sake of analysis, be divided into two parts

'primary deposits', which provide the banking system with the base money (cash-in-tills plus deposits with the central bank); and

'derivative deposits' which, in a proportional reserve system, represent money created by commercial banks in the process of credit expansion and constitute a major source of monetary expansion.

Since derivative deposits lead to an increase in money supply in the same manner as currency issued by the government or the central bank, and since this expansion, just like government deficits, has the potential of being inflationary in the absence of an offsetting growth in output, the expansion in derivative deposits must be regulated if the desired monetary growth is to be achieved. This could be accomplished by regulating the availability of base money to the commercial banks.

**iii) Balance of Payments Surplus:** Only a few Muslim countries have enjoyed a balance of payments surplus in recent years, ~~while~~ most of them have experienced deficits. In the few that did have a surplus, the surplus did not originate in the private sector and did not lead to an automatic expansion in money supply. It did so only to the extent government monetized the surplus by spending it domestically and the private sector balance of payments deficit did not offset this adequately. In the Muslim countries that have a balance of payment deficit, it is unhealthy monetary expansion along with public and private sector conspicuous consumption that generate the balance of payments disequilibrium through current account deficits and underground capital outflows. These

cannot be removed without socio-economic reform at a deeper level and healthy monetary and fiscal policies in the light of Islamic teachings.

#### **5.4.8 Instruments of monetary policy:**

To realize the objectives of monetary policy in an Islamic framework, the central bank in an Islamic economy may use the following instruments, jointly or separately, for regulation of money and credit:

1. *Target Growth in Money Supply:* The central bank should determine annually the growth desired in the money supply (M) in the light of national economic goals, including the desired but sustainable rate of economic growth and the stability in the value of money. This target growth in M should be reviewed quarterly, or as often as necessary, in the light of the performance of the economy and the trend of important variables. However, the targets should not be changed frequently but only when justified to accommodate economic shocks, both domestic and external.
2. *Statutory Reserve Requirements:* Statutory Reserve requirements against the commercial banks' deposit liabilities usually consist of two parts: (a) Compulsory Cash Reserve Ratio (CRR), and (b) Liquidity Ratio (LR). Commercial banks may be required to deposit with the central bank in cash as CRR a certain proportion, say 5-10 percent, of their total deposits from the public. In addition, the banks may be required to keep with themselves shortly maturing liquid assets, say 10-15 percent, against their deposits. These reserves serve the twin purpose of security and control of the banks' capacity to create credit. Reserve requirements against demand deposits may be higher, while requirements against savings and Term (*Mudaraba*) deposits may be lower because of their equity nature, meant for investment by the banks and not supposed to be withdrawn frequently. The statutory reserve requirements may be varied by the central bank according to the dictates of monetary policy.
3. *Credit Ceilings:* It may be desirable to fix ceilings on commercial bank credit to ensure that total credit creation is consistent with monetary targets. In the

allocation of this ceiling among individual commercial banks, appropriate care should be taken to ensure that it does not harm healthy competition among banks.

4. *Allocation of Credit:* Since bank credit comes out of funds belonging to the public, it should be so allocated that it helps to realize general social welfare. The criteria for its allocation, as for other Allah given resources, should be, first, the realization of the goals of the Islamic society, and, second, the maximization of private profit. This could be attained by ensuring that (a) credit allocation leads to an optimum production and distribution of goods and services needed by the majority of the society, and (b) the benefit of credit goes to an optimum number of businesses in society.
5. *Selective Credit Control:* In addition to the general qualitative controls, the central bank may use qualitative or selective credit controls to ensure the flow of credit to the desired direction, purpose and extent. For example, central bank *Mudaraba* financing may not be made available except for specific purposes. The Central bank may also accept a relatively lower profit-sharing ratio, if considered necessary, for realizing the objective of distributing commercial bank financing to an optimum number of businesses for production of the goods and services, which are most needed.
6. *Moral Suasion:* Moral suasion or persuasion should acquire an important place in Islamic central banking. The central bank through its personal contracts, consultations and meetings with the banks could keep itself abreast of the strengths and problems of banks and suggest to them measures to overcome difficulties and achieve the desired goals.
7. *Other Instruments:* For proper functioning of the monetary and credit system and to secure its objectives and mandate the Islamic central bank may also use the following instruments to replace the Bank Rate or Discount Rate and control through regulation of interest rates:
  - a. Fixing a minimum and or maximum ratio of profit for Islamic banks in their joint venture and *Mudaraba* activities. These ratios may vary for different fields of activity.

- b. Designation of various fields for investment and partnership within the framework of the approved economic policies, and the fixing of a minimum prospective rate of profit for the various investment and partnership projects. The minimum prospective rate of profit may vary with respect to different branches of activity.
- c. Fixing a minimum and maximum margin of profit, as a proportion to the cost price of the goods transacted, for banks in installment and hire purchase transactions.
- d. Determination of types and the minimum and maximum accounts of commissions for banking services.
- e. Determination of the types, amounts, minimum and maximum bonuses, and the establishment of guidelines for advertisements by banks.
- f. Determination of the minimum and maximum ratio in joint venture, *Mudaraba* investment, hire purchase, installment transactions, buying or selling on credit, forward deals with respect to various fields of activity; and also fixing the maximum facility that can be granted to each customer.

## **CHAPTER 6: ANALYSIS:**

This analysis is based on our finding findings from the previous chapter. First concept that is analyzed is following:

### **6.1 Time value of money:**

The exploration of juristic opinions relating to loans indicates that there is no double dealing in viewing the economic value of time by allowing a price increase when a commodity is sold on credit and banning a parallel increase on loans. It is more likely in our view - and God knows best - that rulings on both sales and loans do not conflict with the economic value of time. It is true that time alone neither gives a yield nor produces. However, if time is joined to property - whether cash or kind - it acquires an indirect value. A person who gives away a portion of his money to someone else, either on loan or in selling something on credit, cedes, by so doing, potential profits that may be obtained through putting this portion of money to use in an economic activity. These supposed profits are the economic cost borne by the creditor and are the indirect value of time from the perspective of the creditor. On the other hand, the debtor expects - when he either buys on credit or borrows - to obtain benefits through money he does not own. These potential benefits represent the economic return of his debt and are the indirect value of time as far as he is concerned.

In this sense, we see that Al-Imam Fakhruddin Al-Razi accepts that there is an economic value of time in the context of a loan as much as in a sale. This is also the general meaning of the words of Al-Imam Al-Kassani that the immediate is better than the deferred and the asset in hand is better than the loan. It should be pointed out, though, that recognition of an indirect economic value of time does not necessarily mean acknowledging the validity of providing for equivalent material compensation for this value in all cases.

We have already seen that compensating for the value of time in sales is acknowledged in the preponderant views of jurists. In loaning, however, the Quranic ban on increase (interest) means a ban on the material compensation for time, countervailing this

compensation with the reward lavished by God on the creditor if he sincerely acts for God's sake. This is why a loan is considered as a donation, not an exchange.

We further believe that, in addition, the rationale, or wisdom, of banning *riba* is to direct Muslims to seek and adopt other means than loans to finance their economic activities, assigning loans to the area of social solidarity among Muslims. Negation of the economic value of time in the case of a loan means that time is treated differently in loans and sales. Thus, we reach the following important conclusion.

Provisions of sales and loans in Islamic jurisprudence fall within a single concept of time where time is recognized as having an economic value. However, time may be treated differently in sales and loans for reasons we indicated above to the best of our knowledge, although ultimate knowledge rests with the Almighty God of all creation.

## **6.2 Islamic Venture Capital Finance:**

Venture capital is a lucrative industry not only for investors but also for the overall advancement and development of economic and innovative activity. Even though some financial instruments used in conventional venture capital structures are not compliant with Sharia guidelines, there are alternatives already available and used on the conventional side that can immediately be used by the Islamic venture capitalist. There are also new Islamic instruments being developed to address other investor concerns.

A few Islamic financial institutions have been involved in venture capital deals. Their approach, however, has been more as a provider of funds rather than a lead investor. Such institutions tend to rely on the knowledge and expertise of others and would simply 'piggyback' on the transaction. Islamic institutions are slowly realizing the potential of this industry and are more willing to take a leading role in private equity deals. The potential for purely 'Islamic' venture capital is large. There are many Muslim entrepreneurs living in developed countries that are seeking Islamic VC. In Silicon Valley, for example, there have been several high-tech start-ups launched by Muslims and attracted the attention of mainstream VC companies. Since Islamic financing was not available to them, the entrepreneurs opted for conventional financing. There is clearly an opportunity for an Islamic financial institution to create a niche market that specifically targets Muslim entrepreneurs in high-tech hotbeds like Silicon Valley. This is not to say

that there are no opportunities in developing countries. There has recently been a \$50 million venture capital fund launched by the Islamic Development Bank (IDB) that is targeting high tech ventures in Muslim countries.

### **6.3 Islamic Securitization:**

Since its debut in the early 1970's, securitization has grown into a significant business, with credible players and definable rules. It is driven by enactment of various legislation, which made the widespread use of securitization possible. Securitization created net gains for the community as almost everybody gained something from the process. It reduced overall industry concentration risks, resulted in better transparency of operations, imposed industry bench-marks, created significant fee-income for originators and investment bankers, reduced cost of funding to businesses and consumers, and provided better returns for investors.

As information about pools of assets become more and more available -through more extensive use of electronic information providers like the Internet, through deregulation of global financial markets, and as a result of on-going globalization of banking and finance - it is envisioned that securitization business will only grow. The trend is also consistent with the growing demand for disintermediation in the financial markets, which is widely documented.

Islamic institutions, on the other hand, have all along promoted a philosophy in financing based on direct asset financing, rather than lending funds to entities and individuals. They have all along suffered from having to deal with financial intermediaries whose interest-based products are not Islamically acceptable. Securitization enables Islamic institutions to by-pass these shortcomings by engaging themselves directly with the assets to be financed, and with investors in the pools of these assets. It also enables Islamic institutions to negotiate the Islamic acceptability of the terms under which the users hold these assets.

Because of these benefits, we consider securitization as yet another venue for Islamic institutions to demonstrate their competitiveness and to broaden their market.

#### **6.4 Role of Central bank in Islamic Financial System:**

In previous chapter, we have explained how central banks would operate in the Islamic Financial setup. We also saw that role of central bank is as important in Islamic Financial system as it is in the traditional financial system.

Islamic Central bank responsibilities resemble that of traditional central bank except for its added responsibility to work as a regulatory institution that will ensure that the system is working according to the facets of Islam.

As far as I have analyzed the concept of central bank in Islamic Financial system, it generally performs the same functions as traditional Islamic bank. Central bank in Islamic system is the sole body that implements, with the support of Ministry of Finance, the Islamic system. In case of Pakistan, State Bank of Pakistan has given license to certain banks to operate as full or partial Islamic banks and devised regulations for them. These Islamic Banks are working parallel to the traditional banks and customers have the choice of selecting their favored mode of banking. Figures have shown that more and more people are opting for Islamic financial system and its popularity is increasing in the masses.

However, monitoring cost in Islamic banking compared to the conventional banking is relatively high. This is because of the fact that Islamic system has more concentration on the partnership while traditional banking system works on the basis of collateral. This adds to the difficulty of Islamic Central bank who has to do excessive monitoring of the system and the prevailing opportunities. Maintaining liquidity in this system also becomes difficult for the central bank as collapse of business might create liquidity crises. Islamic scholars and jurists have efficiently handled all these problems and created solutions to them. A lot of research work is still in the process to update this system. Although costs are high but still the potential benefits as to its effects on reducing unemployment and keeping prices constant over-shadow the cost. Most important, distribution of income and wealth is expected to be more equitable than otherwise. Such a scheme of distribution guarantees sustained economic development. The role of an Islamic central bank in a uniform distribution of information and prevention of moral hazard cannot be overstated.



## **CHAPTER 7: CONCLUSION AND RECOMMENDATIONS:**

Islamic Banking has shown tremendous opportunity in terms of growth and market share. Islamic banking has achieved a lot in the last few decades. It has not only developed new products, which are in par with the conventional banks, but also successfully brought out innovative new products that are in par with the international financial markets. Islamic banks are successfully adding breadth and depth to its products and services by successfully adding new products and increasing the range of existing products for different target segments of the society. Islamic banks and financial institutions have successfully wooed the Islamic investors and now it's grabbing the target market of conventional banks. The overall profitability of Islamic banks and financial institutions is increasing and a lot of new banks and other institutions are emerging. Much of the credit for this development goes to Islamic scholars and economists, who are trying their level best to make Islamic finance successful and in par with the international requirements. The success of Islamic finance would not have been possible without the hard work and persistent efforts of our scholars. With their hard work, they have proved that Islamic model of Finance is much better than the conventional banking system as it gives due consideration to the poor people of the society and don't believe in their exploitation. The basic theme of Islamic system, which concentrates on forming partnerships rather than keeping collateral, encourages entrepreneurial activity in the society. This entrepreneurial activity results in a lot of new and innovative organizations which becomes an integral part of the overall growth of the economy. The more this system gets developed, the more people will flock to its adoption and hence the overall society will benefit from it. As this system gets developed and becomes a feasible alternative to the conventional banking system, more institutions will adopt it. The recent fund raising by Etisalat Group

of \$2.3 billion shows the immense potential of this sector. This was the single largest fund raising through Islamic modes. The lead bank to the issue is HSBC Amnaah. Now as this system get popular more institutions will adopt it, more research will be done in this field and new products and services would be added to the already existing list. As a positive step, many renowned institutions are offering degrees in Islamic Finance and banking. The research work carried out by the academia would help establish solid concepts of Islamic finance and banking. Famous journals on Islamic Financial systems have been introduced in the market to share the research done in this field among the concerned people. Research work to these journals comes from almost all corners of the world and shared among the scholars and students of Islamic Finance. Field of Finance is fast evolving and hence to keep pace with this evolving financial world, Islamic financial institutions and research scholars need to do a lot and put hard work into practice.

To cut the long discussion short, this research paper has identified a lot of new concepts in Islamic Banking and Finance and identified possible future avenues for Islamic banking and finance. As time passes and more interest is shown in this field, it is hoped that a lot of other things would be added to it. This would enable Islamic banking and finance to become a feasible alternative to traditional and conventional banking system.

### **7.1 Recommendations:**

#### **Formation of full fledged Investment Bank:**

1) Few decades back when the concept of Islamic banking was introduced, it lacked necessary instruments to cope up with the traditional banking system. As already mentioned, traditional banking system took centuries to mould into its present state. Hence it was a big challenge for the Islamic banking system to come up with such a system in a short period of time, which might be compatible with the demands of the modern financial system. This would not have been possible without the hard work and

continuous effort of Islamic scholars and financial experts to design this system. Although the present system of Islamic banking has fulfilled the generic demands of the financial industry but still it lags behind in certain areas. Islamic jurists and experts need to design their own new products to cope up with increasingly innovative new products emerging in the financial industry of the world. They need to make new institutions which will be able to perform major tasks of the conventional Investment banking. Such tasks might include:

- Security underwriting
- Company valuation
- Financial analysis
- Venture capital finance
- Opening up of new funds
- Issuance of Islamic bonds

The above mentioned are some of the areas where Islamic banking can enter to satisfy the demands of their diverse range of customers.

#### **Creation of Islamic Venture Capital Firms:**

2) Islamic Venture capital finance should be introduced in the economy. Venture capital finance has tremendous demand in the growing economies of the world and hence Islamic banks can make separate departments for it. Islamic Venture Capital Finance companies will be based on the finding of the research carried out by different scholars in America. Their research has proved the feasibility of Islamic Venture Finance companies.

#### **Issuance of Islamic Bonds in international markets:**

3) International Bond Market has shown tremendous growth in the past few decades and its still growing. With the opening of international markets and trade liberalization, more and more countries need to raise money through these bonds. Countries want to reduce their reliance on IMF and World Bank, that's why they are issuing their own bonds. Islamic banks and other financial institutions need to cope up with this trend and satisfy the demands of some rich countries who are more interested in Islamic Bonds. The recent successful issue of Pakistan First Islamic Bond shows the tremendous opportunity in this sector. Islamic financial institutions can earn a lot from this particular area.

**Up gradation of Office Security System and effective introduction of KYC:**

4) In the fast changing international scenario after 9/11, the reputation of Islamic Financial institutions and banks have suffered a lot. Islamic Banks should concentrate on this changing scenario and should install better check and balance system to stop terrorists from utilizing their resources for funding global terrorism. Islamic banks should install better tracking system of their clients and should try to stop money laundering. They should market their self as independent institutions whose clients are responsible citizens of the world. Moreover, they should concentrate on KYC i.e Know Your Customer. In this way they can curb the global money laundering.

**Penetration into the Market of Islamic countries and West:**

5) Islamic banks should penetrate in all major markets of the world and should open up their branches in all those countries where they have their client base. Muslims constitute one fifth of the world population and are very rich. Hence Islamic banks can target them and take maximum benefits out of them. In this way they can also attract customers from

other religions of the society. Their smooth operations and good returns will benefit the society in large.

**Building Industry-Academia relationship:**

6) Islamic banking and finance should be introduced in universities and academic institutions. This will help in developing industry-academia relationship. This will be a win-win relationship for both parties and will help in building strong basis of this field. Future professional should be equipped with the necessary skills to cope up with the upcoming challenges in this field.

**Effective intervention of government:**

7) In order to implement the Islamic Financial System in Pakistan, a whole hearted effort is required at government and people level. Government can take steps to facilitate the smooth sail of this system and can provide incentives to people to use Islamic system but it can never force someone to use this system. Now at this stage, people come in and they should fully utilize the Islamic financial system, to make it a success. Without the support of people, this system can not be implemented successfully.

**Expertise of Islamic Scholars required in developing Islamic financial system.**

8) Those countries in which Islamic banking is very much developed should utilize its Islamic Banking experts to help other non-developed Muslim countries in implementing Islamic Financial system in their countries.

**Need for a Common platform of Islamic countries.**

9) Countries like Malaysia and Indonesia, who are considered pioneers in Islamic Banking system, should form strategic alliances with internationally renowned banks and financial institutions. Using this forum, they can introduce Islamic banking and finance in the developed economies. Moreover, this join platform will also conduct research in this sector to bring in innovation in this sector; this will help Islamic system to come in line with the modern practices followed by this industry.

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