

Chapter 1

INTRODUCTION

1.1 Aim of the Study

Investigating the determinants of profitability has been one of the more popular topics among researchers in banking studies. For the past three decades, researchers have managed to examine and identify various factors that have a significant influence on banks' profitability. In the process of identifying the determinant factors researchers were able to validate the existence of some profitability theories in banking (details of previous studies and profitability theories related to banking are given in Chapter 5).

All previous profitability studies, however, have been of conventional banks and until now there has been no study to determine the profitability of Islamic banks. Nienhaus (1983) did attempt to link the profitability of Islamic banks and the market structure on a non-empirical basis. Based on a simplistic equilibrium model he postulated that the profit-sharing ratio of the Islamic bank was positively related to the lending rate of the conventional bank. Khan (1983) expanded Nienhaus's model and postulated that the average return of an Islamic bank in the long run will be higher than the interest rate offered by conventional banks. Like that of Nienhaus, Khan's framework was not empirically verified.

The findings of this study, therefore, will serve not only to expand the existing profitability literature but also to pioneer profitability studies of Islamic banking. Specifically, this study has the following objectives:

- a. To investigate factors that contribute towards the profitability of Islamic banks.
- b. To determine the profitability of Islamic banks which operate in two separate markets, i.e. monopolistic and competitive markets.
- c. To test existing profitability theories within the Islamic banking system.

1.2 Background of the Study

The term "Islamic banking" refers to the conducting of banking operations in consonance with Islamic teachings. Banking practices that involve the receipt and payment of interest are not compatible with the teachings of Islam (Ahmad, 1994). Since interest is considered unlawful, Islamic banks have had to look for permissible forms of rewards, charges and business relationships between the bank and those who provide funds and those who use the same. Islam proposes that the banking system that operates on the basis of an ex-ante fixed rate of interest be replaced by a profit-sharing system in which the rate of return to the financial resources is not known and is not fixed prior to the undertaking of the transaction. While in Islam interest is forbidden, trade and profits are permissible and in fact encouraged. An uncertain rate of return based on profits would thus be consistent with *Shariah* (Islamic law). From this distinction between a certain rate of interest and an uncertain rate of return it follows that, if a banking structure could be evolved in which the return for the use of financial resources fluctuated according to actual profits made from such use, the resulting system would be in conformity with Islamic rules and guidelines.

Muslim jurists and scholars have suggested many *Shariah* principles to be adopted by Islamic banks in delivering their products and services to their customers. These

principles can be broadly classified into four categories, namely, principles that are based on profit-loss sharing, principles that are based on fixed charges, a charge-free principle and finally ancillary principles, i.e. principles that are applicable directly or indirectly to the operations of Islamic banks (explained in detail in Chapter 3).

This concept of banking was pioneered by Mit Ghamr Local Saving Bank, which was established in 1963 in a provincial rural centre in the Nile Delta of Egypt. According to Siddiqui (1996), there are currently more than 175 interest-free institutions all over the world providing services that are compatible with those services offered by interest-based institutions or conventional banks (a list of Islamic financial institutions is provided in Appendix 1). In 1989, it was estimated that between \$US 20 billion and \$US 40 billion of assets existed in the Islamic banking system world wide (Syedain, 1989). More recently, the assets have grown to \$US 60 billion (De Belder and Khan, 1993).

These Islamic banks not only serve the needs of Muslim customers but have also extended their operations to service non-Muslims. Bank Islam Malaysia Berhad, for example, as at the end of August 1993, had 350,000 customers of whom 17,000 were non-Muslims. Islamic banks have also extended their undertakings to the Western world. Islamic Banking System International Holding, for example, was established in Luxembourg in 1978, becoming the first Islamic institution in the Western world, followed by Dar al-Mal al-Islami in Switzerland (1981) and the Islamic bank International in Denmark (1983). Islamic banks have also expanded their operations to former Soviet block countries. The Al-Baraka group now has its own bank in Kazakhstan by the name of Al-Baraka Kazakhstan and this group is aiming to form a new Islamic bank on a joint-venture basis in Uzbekistan (Rudnick, 1992).

The commitments of Governments also play an important role in assisting the development of the Islamic financial system. In Malaysia, for example, the

government has given its full support to the development of an interest-free financial system functioning side-by-side with the conventional system (Parker, 1993). By the beginning of 1993, a total of 21 Islamic banking products were successfully developed by the Central Bank of Malaysia and as at the end of the same year a total of 21 financial institutions participated in the interest-free banking scheme. Another breakthrough in the Islamic banking system in Malaysia was the implementation of an Islamic inter-bank money market, launched on January 3, 1994. This market covers three aspects: inter-bank trading in Islamic financial instruments; Islamic inter-bank investments; and an Islamic inter-cheque clearing system (Bank Negara Malaysia, 1994).

For more than a decade since their inception, Islamic banks have not only managed to establish themselves as a viable alternative to conventional banks but have been able to improve themselves in terms of profitability and patronage. Faysal Islamic Bank of Bahrain (FIBB), for instance, managed to increase its net profit after tax from \$US 4.3 million in 1988 to \$US 16 million in 1994 (FIBB 1994 annual report). Similarly, Dubai Islamic Bank of the United Arab Emirates generated approximately 11 million Dirhams profit in 1988 and increased it to 17 million Dirhams in 1992. Bank Islam Malaysia Berhad (BIMB) increased its net profit before taxes from \$US 4.6 millions in 1989 to \$US 13 millions in 1994. In terms of numbers of depositors, the Faisal Finance Institution of Turkey, for example, had increased the number of deposit accounts from 5,200 accounts at the end of 1985 (its first year of operations) to 82,760 accounts at the end of 1993. At Jordan Islamic Bank, there were 50,000 depositors at the end of 1984 and this figure increased to 350,000 at the end of 1993.

1.3 Justification for the Study

There are two main reasons for this study: first, the non-existence of profitability studies for the Islamic banking system; second, to determine if the existence of government protection in some Muslim countries, by creating monopolistic markets in Islamic banking, contributes towards profitability.

In the process of maximisation of returns, conventional banks attempt to structure their portfolio of assets in such a manner as to yield the greatest return subject to various constraints. The assets held by a bank may be divided into two broad classes, frequently called earning assets and non-earning assets. Earning assets comprise two balance sheet items called loans and investments. Non-earning assets consist of cash and bank balance, fixed assets, and total reserves of the banks. A bank can usually increase the yield on its earning assets by reducing its liquidity. One of the basic concepts of asset management, however, is that a bank should not merely attempt to maximise short-term yield. Under normal economic conditions, such action would require lengthening of maturity and possibly increasing the default risk of the earning asset portfolio. This could eventually result in the bank's inability to meet its loan demand and deposit withdrawals and, perhaps, even lead to insolvency. On the other hand, any bank that maintains an excessive liquid earning assets' portfolio is unnecessarily forgoing profitable opportunities.

Finding an appropriate balance between profitability, risk, and liquidity consideration is central in portfolio management. The optimal balance between these factors cannot be found without considering important interactions that exist between the structure of a bank's liabilities and capital and the composition of its assets. In the case of conventional banks, there is an abundance of literature which indicates the critical areas in managing the bank's assets and liabilities. The existence of such literature together with computer packages that assist in the decision-making process makes the

task of allocating these assets much easier for conventional bank managers. Besides providing information about the critical areas in assets-liabilities management, banking scholars are able to furnish bank management with information about the impact of the external forces on bank profitability. These external forces include factors such as regulation, competition, concentration, market share, capital scarcity, and inflation.

In the case of Islamic banks, however, the absence of literature which specifically deals with their profitability has created an information gap. There are several possibilities for Islamic banks to fill this gap. First, Islamic banks could use a trial-and-error method for their assets-liabilities management, hoping that at the end of the day they will find the optimal combination. Second, they could use existing conventional banking literature as a guide and presume that the profitability determinants of conventional banks have a similar impact on Islamic banks. While trial-and-error methods are time-consuming and sometimes costly, assuming that the factors that influence conventional bank profitability have the same impact on Islamic banks means acknowledging that there is no difference between Islamic and conventional banks. This acknowledgment could contribute to serious repercussions.

Most of the existing Islamic banks in Muslim countries were established in the 1970s and early 1980s. After being more than a decade in the market place some banks are still enjoying monopolistic status while others have to compete with other Islamic banks. In countries such as Bangladesh, Jordan, Kuwait, Malaysia and the United Arab Emirates there is only one full-pledged Islamic bank, whereas in Bahrain, Egypt, Sudan, and Turkey there are many such banks. The existence of these two markets, monopolistic and competitive, raises certain fundamental issues. In the case of the monopolistic market, for example, questions arise as to whether such a market exists because of the protectionist policy established by the respective government or because no other parties are interested in establishing new Islamic banks.

Historically, the governments of many Muslim countries have played key roles in promoting the establishment and development of Islamic banks. Although efforts to introduce these banks were channelled mostly through isolated private and individual initiatives, government intervention has been inevitable in ensuring that these banks will survive in the market. There are various forms of assistance given by government. In the case of Faisal Islamic Bank of Sudan (FIBS), for example, its establishment was carried out under the FIBS Act which exempted the bank from the application of rules and laws regulating banking services, insurance, auditing, and payment of taxes on profit. These concessions were intended to encourage the bank to compete with the existing banks (Ahmed, 1990). In Malaysia, a special law was enacted by government called "The Government Investment Act, 1983", which empowered the government to issue bonds on an Islamic basis. By issuing bonds on this basis, the government has created an investment avenue for the Islamic bank. Although the Government of Kuwait owned 49% shares of Kuwait Finance House, its supervision is not within the jurisdiction of the Central Bank of Kuwait.

One of the basic objectives of regulation in the conventional banking system is to provide a competitive environment that prevents domination of the financial services industry by a handful of giant firms. Monopoly is always associated with high prices for services and inefficiency. Research into conventional banking has indicated that there is no evidence that larger banks are taking advantage of economies of scale. Competition is desirable because it affects performance and the allocation of scarce resources. In effectively competitive markets, firms of non-optimum scales are forced to make scale changes or fail.

In the absence of research which relates directly to the profitability of Islamic banks, this study is considered appropriate and timely. In line with its objectives, this study is expected to contribute significantly to the following areas:

- a. The findings of this study will serve as the first empirical evidence with regard to the profitability determinants of Islamic banks. Both internal and external determinants of bank profitability will be examined by this research. While some of the variables are common to both Islamic and conventional banks (e.g. funds in various types of deposits and expense items), other variables are applicable only to Islamic banks (e.g. funds used for financing, based on profit-sharing, finance based on mark-up basis, and profit distributed to investment depositors).
- b. This study will provide an answer to the question as to whether the determinants of profitability of conventional banks are similar to those of Islamic banks, and vice versa.
- c. This study will serve as an indicator of whether the protectionist policy practised by some Muslim countries towards Islamic banks is indeed an appropriate policy.
- d. This study will examine existing profitability theories available in conventional banking literature. Theories such as expense-preference and risk-aversion exist as a result of the policies adopted by the management of the bank; the existence of such theories in Islamic banks serves as an indicator that there is a similarity in attitude and management style of both banks.
- e. The findings of this study will serve as a foundation for future profitability studies of Islamic banking.

1.4 Definitions and Scope of the Study

This study is conducted within the boundaries set by the following definitions, conventions and limitations.

Islamic Banking System

Islamic banking system includes all Islamic financial institutions whose operations are in consonance with the ethos of Islam and operate without any element of interest. For this study, however, the samples are confined to Islamic banks.

Islamic Bank

An Islamic bank is an institution which engages in banking business such as accepting deposits in the form of current, saving and investment accounts and providing financing facilities based on Islamic or *Shariah* principles. Other activities include remittances, money-market, international trade and advisory services. The nature of activities of this bank is similar to any commercial bank.

***Shariah* Principles**

Shariah principles are the rules which govern the operations of Islamic banks. Since Islam prohibits interest, these principles are the acceptable mode of operations to be used by Islamic banks in delivering their services.

Schools of Law

Basically Muslims are divided into two groups, i.e. Sunni and Shi'i. The latter are people whose forefathers believed that Ali was the right successor after the Prophet Muhammad (peace be upon him), while Sunni believed otherwise. There are four dominant Sunni schools of law, better known as *madzhab*, namely Hanafi (Arab Middle East and South Asia), Maliki (North, Central and West Africa), Shafii (East Africa, Southern Arabia, and Southeast Asia), and Hanbali (Saudi Arabia). Shi'i Islam also generated its own schools. The three most prominent branches of Shi'ism are the Zaydis, the Isma'ilis and the Ithna-asharis. Each school of law sometimes has its own opinion on *riba*. The variation in opinions among these schools of law will not be discussed in detail as they are beyond the scope of this study.

Usage of Terminologies

Arabic words (*in italic*) are widely used in Islamic banking literature. These words will be used in this study in order to maintain their legitimacy.

Comparison of Ideology

This study will focus solely on a Muslim perspective. Opinions from other religions such as Christianity and Judaism pertaining to interest and usury will not be discussed.

Comparison with Conventional Bank

No detailed discussion will be conducted regarding the conceptual or operational differences between the Islamic banking and conventional banking systems.

Usage of the Koran

The Koran is the Muslims' Holy Book and serves as an original and eternal source of Islamic law. It constitutes messages with which Allah inspired the Prophet (peace be upon him) for the guidance of mankind, and it was revealed in Arabic. The Koran which is used for this study was originally translated into English by Abdullah Yusuf Ali (1872-1948) and revised by the late Ismail Raji al Faruqi, who was the President of the International Institute of Islamic Thought, USA. The new revised text was published in 1989 and entitled 'The Holy Qur'an: Text, Translation and Commentary'.

Numbers in Parentheses

Numbers appearing within brackets refer first to the *sura* or Chapter number and then the *ayat* or Verse number in the Koran. (2:275) would therefore mean Chapter 2, Verse 275.

***Riba* Among the Muslims**

Riba can originate from two sources, i.e. debt and sales (cash and barter). This study, however, will focus only on *riba* from the Islamic banking perspective.

Selection of Samples

The sample was drawn from Islamic banks currently in operation. Letters asking them to supply financial statements for the past 10 years (or since commencement of business in the case of their establishment being less than 10 years) were sent to either the Executive Director or the General Manager. A total of 32 letters were sent to various banks in 17 different countries.

Nineteen banks responded positively by providing their financial statements as requested. The other banks did not respond although several reminders were sent to them. Out of the 19 banks which did respond, six banks were excluded from the study. This is because two of them provided financial statements for a single period, two other banks were investment banks and the annual reports of two other banks were incomplete and not useful for the study (names of banks and countries where letters were sent and banks which responded to the request are given in Appendix 2). Since only 13 banks were selected as samples, they would not represent the total population of Islamic banks as non-responsive bias could not be estimated

Operational Aspects and Practices of the Individual Banks

Letters and reminders were sent to all 13 banks selected for this study requesting them to provide additional information about their operational aspects and practices. None of the banks responded to this request. Therefore, the elaboration in Chapter 4 is based on information taken from annual reports, initial correspondence and existing literature. Similar letters were also sent to banks in Pakistan and Iran on a selective basis. Only one bank from each country responded to the request and financial figures from these banks were used for comparison purposes. The inclusion of the operations and practices of Pakistani and Iranian banks is important because these two countries have Islamised their banking system.

Usage of Annual Reports

The data for this study were taken from the annual report supplied by the bank. The list of participating banks and years of data is presented in Appendix 5. In some cases, the data are adjusted and reclassified to suit the type and nature of internal variables selected for this study. All data are considered valid for

usage. In the case where a standard parameter is needed (e.g. size of bank), conversion is made into common currency, i.e. US dollars based on the year-end exchange rate taken from the annual reports of the International Monetary Fund. A majority of the samples present data as at the end of the calendar year (December 31st).

1.5 Organisation of the Thesis

The thesis is organised into eight chapters. After the introductory first chapter, Chapter 2 elaborates the theoretical and conceptual aspects of Islamic banking. This elaboration includes the philosophy and objectives of Islamic banks, the concept of *riba* and the relationship between Islamic banks and their suppliers and users of funds. While Chapter 3 explains the laws and regulations governing the operations of Islamic banks, Chapter 4 elaborates on the practices and operational aspects of these banks. Chapter 5 contains a review of the literature which serves as a foundation and guideline for the development of a model for the study. Chapter 6 explains the reasons for the selection of variables used in this study and the methods used in validating the effects of variables on the profitability of Islamic banks. The results and statistical inferences are given in Chapter 7. Chapter 8 presents a summary and conclusions for this study. Recommendations for further research and limitations to this study are also highlighted in this final chapter.

Chapter 2

THEORETICAL AND CONCEPTUAL ASPECTS OF ISLAMIC BANKING

2.1 Introduction

After more than a decade since their establishment, Islamic banks are now in a position of providing almost all basic banking facilities to their customers. Deposit facilities such as current, savings and fixed term accounts, as well as financing facilities, are available in almost all Islamic banks. They also serve as pipelines through which currency moves into and out of circulation and, in addition, provide facilities for making domestic and international payments. Some Islamic banks have provided more sophisticated facilities such as managing syndicated loans and becoming underwriters in the process of issuing Islamic securities.

Islamic banks are considered as the end product of the Islamic resurgence which had taken place within Islamic communities especially during the end of the 1960s and the early 1970s (Khan and Mirakhor, 1987). One of the most important issues which had been widely discussed during this period was the transformation of the economic order from capitalist to Islamic. Since the elimination of interest has generally been the first step in the Islamisation of the economy, it is perhaps only natural that the formation and the operation of Islamic banks be given the most attention. The highest acknowledgment of the needs of establishing interest-free financial institutions was given by a group of experts from 18 Islamic countries in 1970. They recommended that the interest-based financial systems should be replaced by a system of

participation schemes linked with profit and loss sharing. This group of experts was commissioned by the Islamic Countries' Foreign Ministers during their second conference in Karachi in December 1970. This recommendation led to the establishment of the Islamic Development Bank in 1975 and the International Association of Islamic Banks in 1977. At the same time many Islamic banks were established in Muslim countries around the world.

As an institution whose foundations are based on religious doctrines, the establishment and operations of Islamic banks have raised many theoretical and conceptual considerations. As mentioned by Ali (1988):

The 'Islamic Economic Order' is based upon a set of principles found in the Quran. No matter what aspect of the Islamic Economic Order is introduced, for practical operations it has to base itself on the Qur'anic concept of social justice. The Islamic financial system, therefore, cannot be introduced merely by eliminating *riba* but only by adopting the Islamic principles of social justice and introducing laws, practices, procedures and instruments which help in the maintenance and dispensation of justice, equity and fairness.

(Ali, 1988, p. 3)

Thus, Islamic banks do not have similar objectives and philosophies to other business entities. Their objectives and philosophies are in line with the revelations in the Koran.

The main objective of this chapter is to highlight the philosophies of Islamic business. As an entity that is established within the ambit of Islamic law, an Islamic bank is expected to be guided by these philosophies. Establishing the right philosophies is important for any Islamic bank for two reasons. Firstly, these philosophies will be used by the management or policy makers of Islamic banks in the process of formulating corporate objectives and policies. Secondly, these philosophies serve as

an indicator as to whether the particular Islamic bank is upholding true Islamic principles. Besides highlighting the general objectives of Islamic banks, this chapter will also discuss other theoretical and conceptual issues such as how Islamic banks source and use funds, the relationship with the suppliers and users of funds, and finally the prohibition of *riba*.

2.2 The Philosophy of Islamic Business

Islam permits and encourages its followers to involve themselves in trade activities. As stated in the Koran in verse 275 of chapter 2:

“But Allah hath permitted trade and forbidden usury...”

The Prophet (pbuh-peace be upon him) in his early life used to be a trader and, similar to many of his eminent companions, was a businessman. From the religious perspective, the establishment of Islamic banks is considered a righteous move for two reasons. Firstly, its existence is in line with the divine revelation, i.e. to engage in trade. Secondly, Islamic banks provide an avenue for Muslims to perform banking business in the Islamic way, i.e. free from any element of usury.

Eliminating the element of usury in the banking system is only part of the Islamic business principles. Being established as an Islamic business entity, all Islamic banks not only have to conduct their business with the objective of making profit but at the same time must conform to the Islamic business principles. Islamic banks are also expected to adhere to the rules and laws which are directly imposed on individual Muslims, otherwise the entities are not qualified to be called Islamic institutions. Thus, whatever law is imposed on Muslim individuals is also applicable to Islamic banks. This relationship leads to the philosophical questions “What should the Islamic

banks. This relationship leads to the philosophical questions “What should the Islamic banks do, and what should the banks believe?” For Muslims, the answer to these questions were given by the Koran in many of its verses; verse 132 of chapter 3, for example, says:

“Obey Allah and the Messenger; that ye may obtain mercy.”

Furthermore, in verse 59 of chapter 4, the Koran highlights:

“O ye who believe! Obey Allah, and obey the Messenger....”

Therefore the foundations of the philosophy of Islamic banking are those principles which have been revealed in the Koran and the *hadith* or traditions of the Prophet (pbuh). Whichever revelation directly or indirectly requires Muslims to uphold justice and virtue is used by Islamic banks as principles for guidance in their business affairs.

The principles of Islamic business comprise honesty and the notion that trade is to be conducted in a faithful and beneficial manner. Islam conceives trade as an honest effort, an earnest endeavour, and human striving for earning one's rightful livelihood. Trade manipulations and malpractices aimed at earning undue profit through operations like hoarding, black-marketing, profiteering, short-weighting, hiding defective quality of merchandise, and adulteration cannot be regarded as honest trade (Siddiqi,1986). The Prophet (pbuh) was once given a title of '*amin*' or trusted because of his honesty in all dealings. The operations of Islamic banks, therefore, are based on the concepts of honesty, justice and equity as practised by the Prophet (pbuh).

The meaning of righteous trade can best be understood from the metaphorical content of chapter 35, verse 29 of the Koran which says:

“Those who rehearse the Book of Allah, establish regular prayer, and send (in charity) out of what We have provided for them, secretly and openly, hope for commerce that will never fail.”

This passage teaches Muslims that the godly man's business will never fail or fluctuate because Allah guarantees him the return, and even adds something to the return out of His own bounty. Analogically, honest trade will lead to the earning of profit in this world as well as in the hereafter. Tarmidzi (circa 892) reported that the Prophet (pbuh) mentioned that, “The truthful, honest merchant is with the Prophet, truthful and martyrs.” (Siddiqi, 1989 p. 4).

In the process of conducting business, Islamic banks seek to bring about a lasting balance between earning and spending in order to achieve the target of the betterment of the whole community. Islam has always emphasised the lawful earning of livelihood. All unlawful means of acquiring wealth are prohibited. Chapter 4, verses 29 and 30 of the Koran, states:

“O ye who believe ! eat not up your property among yourself in vanities; but let there be amongst you traffic and trade by mutual goodwill; Nor kill (or destroy) yourself: for verily Allah hath been to you most merciful. If any do that in rancour and injustice- soon shall we cast them into fire: and easy it is for Allah.”

In terms of spending, Islam demands that its followers spend money for the welfare of the people and not for wasteful or pleasurable activities. This directive is given in verse 219 of chapter 2 of the Koran which says,

“They ask thee concerning wine and gambling. Say, “In them is great sin, and some profit, for men; but the sin is greater than profit.” They ask thee how much they are to spend; say “What is beyond your needs.” Thus doth Allah makes clear to you his sign; in order ye may consider.”

Verse 36 of chapter 4 of the Koran also outlines the right conduct for Muslims, which is applicable to Islamic banks in conducting their business. It says:

“Serve Allah, and join not any partners with Him; and do good to parents, kinsfolk, orphans, those in need, neighbours who are near, neighbours who are strangers, the companion by your side, the wayfarer (ye meet) and what your right hands possess; for Allah loveth not the arrogant, the vainglorious.”

In dealing with their customers, Islamic banks are expected to conduct the transactions for the benefit of both, i.e. the banks and the customers, and to uphold the concept of justice. Besides what was revealed in chapter 4 verse 29, chapter 4 verse 135 of the Koran says:

“O ye who believe! stand out firmly for justice, as witnesses to Allah, even as against yourself, or your parents, or your kin, and whether it be (against) rich or poor: for Allah can best protect both. Follow not the lusts (of your hearts), lest ye swerve, and if ye distort or decline to do justice, verily Allah is well-acquainted with all that ye do.”

Again in chapter 16, verse 90 it is stated:

“Allah commands justice, the doing of good, and liberality to kith and kin, and He forbids all shameful deeds, and injustice and rebellion: He instructs you, that ye may receive admonition.”

These passages require Muslims to uphold justice irrespective of any blood relationship or status. Applying these verses to the context of business entities, Islamic banks will treat their customers equally. This concept of justice is extended by Islamic banks when imposing charges on customers and also when fixing the

profit-sharing ratio either with their investors or with their business partners. This philosophy is also reinforced by verse 87 of chapter 5 of the Koran:

“O ye who believe! make not unlawful the good things which Allah hath made lawful for you, but commit no excess; for Allah loveth not those given to excess.”

Mannan (1986) is of the opinion that, in an Islamic social system, welfare is maximised if economic resources are so allocated that it is impossible to make any one individual better off by any rearrangement without making anyone or some others worse off within the framework of the Koran and *Hadith*. Anything which is not expressly prohibited in the Koran and *Hadith* but is consistent with the spirit of the same may be styled as Islamic. Mannan (1986) believed that it is not harmful for Islamic banks to carry out business activities as long as its not prohibited in the Koran or *Hadith*.

In Islam, the absolute ownership of everything belongs to Allah. As stated in verse 189 of chapter 3:

“To Allah belongeth the dominion of the heavens and the earth; And Allah hath power over all things.”

This absolute ownership does not imply that Allah has created everything for Himself. On the contrary, it is stated in verse 29 of chapter 2 that,

“It is He who hath created for you all things that are on earth; then He turned to the heaven and made them into seven firmaments. And of all things He hath perfect knowledge.”

Mannan (1986) claimed that this verse emphasises that what Allah has created belongs collectively to the whole of human society. Legal ownership by the individual, that is to say the right of possession, enjoyment and transfer of property, is recognised and safeguarded in Islam, but all ownership is subject to a moral obligation. This moral obligation is stated in verse 19 of chapter 51 of the Koran:

“And in their wealth and possessions (was remembered) the right of the (needy), Him who asked, and him who (for some reasons) was prevented.”

As for Islamic banks, while making profit from the business is allowable in Islam the accumulation of profit without utilisation for the betterment of the community is forbidden. Because of this revelation, Islamic banks are expected to be sensitive to the needs of society, promote social programs and activities, and make contributions towards the needy and poor families.

Islam prohibits accumulation of wealth or its unrestricted possession by individuals exclusively in their self-interest. Besides that, Islam commands that even wealth which is earned by the right means should not be hoarded in selfish interest because it would impede growth in the economy, thus creating social imbalances. Verse 3 of chapter 180 of the Koran says:

"And let not those who covetously withheld of the gifts which Allah hath given them of His Grace, think that it is good for them; nay it will be the worse for them; soon shall the things which they covetously withheld be tied to their necks like a twisted collar."

Again in verses 1 to 4 of chapter 104 it is reiterated:

“Woe to every (kind of) scandalmonger and backbiter, who pileth up wealth and layeth it by, thinking that his wealth would make him last forever! By no means, he will be sure to be thrown into that which breaks to pieces.”

Three vices mentioned by the above verses are here condemned in the strongest terms: (i) scandal mongering, talking or suggesting evil of men or women by word or innuendo, or behaviour, or mimicry, or sarcasm, or insult; (ii) defaming a person’s character behind their back where the motive is evil, even if the things commented are true; (iii) accumulating wealth not for use and service to those who need it, but in miserly hoards, as if such hoards can prolong the miser's life or give him immortality; miserliness is itself a kind of scandal (Ali, 1989). Revelations in chapter 104 serve as a reminder to those who manage Islamic banks to be more cautious in managing the assets. Islamic banks are prevented from accumulating wealth without any purpose. The wealth should be spent on the needy and for the betterment of the whole society. Failing to conform with the instruction from Allah means there is a great possibility that the wealth accumulated by the banks will be destroyed. The destruction may be in the sense that the bank will not be able to make profit and ultimately have to cease business.

The Koran in many of its verses indicates the principles which serve as guidance for the Islamic banks in their practical affairs. Banks involving themselves in business is highly encouraged by Islam but the business must be conducted on the basis of equity and justice. Islamic banks are prevented from engaging themselves in the business forbidden by Islam. During the course of conducting a business, every customer must be treated equally and lavish spending is not allowed. Islamic banks are also expected to make a profit from their business. This profit, however, is not to be accumulated without any specific reasons. Instead, Islam encourages its followers to spend for the needy and for other socially permitted activities.

2.3 The Objectives of Islamic Banks

As suggested by Khan (1983), the rationale for the existence of Islamic banks is to promote, foster and develop banking services and products based on Islamic principles. Islamic banks are also responsible for promoting the establishment of investment companies or other business enterprises as long as the activities of these companies are not forbidden by Islam. The main principles of Islamic banking comprise prohibition of interest in all forms of transactions, and undertaking business and trade activities on the basis of fair and legitimate profit. Islamic banks are to give *zakat* (wealth or alms tax) and to develop an environment which benefits the whole society.

Like any other business entity, Islamic banks are expected to make a profit from their operations. It is considered an injustice if Islamic banks are unable to provide sufficient returns to the depositors who entrusted money to them (Mirakhor, 1987). While making a profit from the business is allowed in Islam, at the same time Islamic banks are required to recognise the message stated in verse 87, chapter 5 of the Koran which prohibits Muslims for committing any excess. Applying this message to banking operations means that Islamic banks are prohibited from making excessive profit at the expense of their customers. Islam also prohibits accumulation of profit without utilisation for the betterment of the community.

Therefore, while ordinary business institutions are likely to view profit as their primary objective, Islamic banks have to incorporate both profit and morality into their objectives. As stated in the 1993 annual report of Faysal Islamic Bank of Bahrain (FIBB), the Dar Al-Maal Al-Islamic Trust (i.e. the holding company for FIBB and 25 other financial and business companies operating on the basis of *Shariah* in 15 countries around the world) established the following objectives for their group of companies:

1. To put before to all Muslims contemporary Islamic financial services, helping to execute their financial dealings in strict respect of the ethical individual and social values of Islamic *Shariah*, without contravening the heavenly imposed prohibition of dealing in *riba* (interest or usury).
2. To serve all Muslim communities in mobilising and utilising the financial resources needed for their true economic development and prosperity within the principles of Islamic justice assuring the right and obligations of both the individual and the community.
3. To serve the '*Ummat Al Islam*' (Islamic communities) and other nations by strengthening the fraternal bonds through mutually beneficial financial relationships for economic development and the enhanced environment for peace.

For instance, Bank Islam Malaysia Berhad's (BIMB) corporate objective is to provide banking facilities and services in accordance with Islamic principles, rules and practices to all Muslims as well as the general population of Malaysia. The Islamic principles, rules and practices are essentially those belonging to the body of Islamic principles on commercial transactions that relate to banking and finance. The bank's efforts to provide these banking facilities and services are undertaken within the framework of its viability and capability to continuously grow and expand (BIMB, 1985). However, Dubai Islamic Bank's (DIB) main objective is to prohibit Muslims from dealing with interest or usury which has been strictly prohibited by Allah and to protect them from one of the biggest sins (undated DIB information leaflet).

The most important feature of the Islamic banks' objective is that the products and services are based on Islamic principles. But for FIBB and BIMB, the viability of

projects and the capability of customers to repay loans are nevertheless important factors to be considered while delivering their services.

2.4 Prohibition of *Riba*

The Oxford Dictionary defines interest as “Money paid for the use of money lent (the principal), or for forbearance of a debt, according to a fixed ratio (rate per cent).” (2nd. Ed., Vol VII, p. 1099). The same source describes usury as “The fact or practice of lending money at interest; especially in later use, the practice of charging, taking, or contracting to receive, excessive or illegal rates of interest for money on loan.” (2nd. Ed. Vol.XIX, p.365). According to Khan (1987), Islam does not differentiate between interest and usury. There is now a general consensus among Muslim scholars and theologians that the terms *riba* covers both interest and usury.

Muslims are totally prohibited from dealing with *riba*. As pointed out by Ahmad (1992) there are no two opinions on the categorical prohibition of *riba* in Islam; there is a difference, however, in the interpretation of scope, term, and meaning. The prohibition of *riba* is not only revealed in various chapters of the Koran, but is also made clear by the Prophet (pbuh) who uses very unambiguous words in condemning the taker and giver of *riba*.

Actually Islam is not the only religion which prohibits its followers from taking *riba*. Christianity, for example, during its early years, never condoned its followers' acceptance of interest. Interest during that time was generally categorised as 'shameful gain' and accepting interest was treated as a serious sin. It was also denounced as a form of avarice and uncharitableness (Noonan, 1957).

Similarly, the Jews in the Old Testament or Hebrew Bible were never allowed to take interest. In Exodus 22:25 and Leviticus 25:35-37 are passages that prohibit Jews from

taking interest with respect to loans granted to the poor among Jews or among strangers who have been incorporated into their community and who share their rights and privileges. These passages also require Jews not to demand more in return than they lend. Seeking profit from the poor is not showing charity or mercy but acting as an extortioner and an oppressor, devouring the needy borrower. All kinds of interest, moderate or exorbitant, are considered a form of extortion and an offence against charity and mercy within the Jewish community (Divine, 1959). Jews however, are permitted to take interest from foreigners. This permission is presented in passages number 19 and 20 of Deuteronomy.

In conjunction with the trade and commercial revival in the twelfth century, the discussion of interest among Christian scholars and theologians was conducted on an increasingly scientific basis. During the Reformation period (1500 -1800) many Protestant leaders defended interest and credit. As a result, the interest doctrine, which had a grip on Jews and Christians for 2000 years, was weakened and finally discarded (Nelson, 1949). During the eighteenth century, more and more types of credit were accepted by the Christian Catholic Church. Finally, after a series of discussions which took place between 1822 and 1836, the Christian Holy Office ended all doubts and practical difficulties among its followers by decreeing that interest was allowed by law and may be taken by everyone (Noonan, 1957).

2.4.1. The Meaning of *Riba*

Riba is an Arabic word and literally means increase (*al-ziyada*), growth (*al-numuw*), to rise (*al-irtifa*) or to become lofty (*al-uluw*) (Ahmad, 1992). Manzur (1223-1312) in his book, *Lissanul Arab* states:

“The root of it is the increase, of the *riba* of money where it has increased.”
(Homoud, 1985, p.47)

Tabiri (circa 923), one of the famous interpreters of the Koran, gave his opinion that the word '*rabia*' or hill was thus called because it is greater in height and overlooks the level of the surrounding ground. Thus, the word '*riba*' can be applied in two different contexts. Firstly, it can be an increase to the item itself and, secondly, it can be an increase resulting from a comparison or a differential between two items (Homoud, 1985).

The word *riba* was also used by the pre-Islamic Arabs. They perceived that *riba* is the basis of the increase of money in consideration of extension of the terms of maturity, either from the date of maturity or from the actual date of the debt. Therefore, in many instances, contemporary Muslim scholars often link the word *riba* with loan and use this pre-Islamic meaning in their elaboration of the word *riba*.

Khan (1987) in his definition of *riba* stated:

“Strictly speaking, the term *riba* refers to the addition to the amount of principal of loan on the basis of time for which it is loaned, or of the time for which the payment is deferred.”

(Khan, 1987, p. 3)

According to Salleh (1986),

“*Riba* in its *Shariah* context, can be defined, as generally agreed, as an unlawful gain derived from the quantitative inequality of the countervalues in any transaction purporting to effect the exchange of two or more species (*anwa*', singular *naw*'), which belong to the same genus (*jins*) and are governed by the same efficient cause (*'illa*, plural, *'ilal*). Deferred completion of the exchange of such species, or even species which belong to different genera but are governed by the same *'illa*, is also *riba*, whether or not the deferment is accompanied by an increase in any one of the exchanged countervalues.”

(Saleh, 1986, p. 13)

2.4.2 The Prohibition of *Riba* in the Koran

The prohibition of *riba* in the Koran developed gradually and appeared in four revelations. The first revelation occurred in Mecca and the three others were in Medina. The first revelation is in verse 39 of chapter 30 which says:

“That which ye lay out For increase through the property of (other) people, will have No increase with Allah: But that which ye lay out for charity, seeking The Countenance of Allah, (will increase): it is These who will get A recompense multiplied.”

The above verse strongly prohibits Muslims from taking *riba* (increase). The principle is that any profit Muslims seek should be through their own exertion and not through exploitation of other people or at their expense. Muslims must also show their love of neighbourhood by spending their own substance or resources or through the utilisation of their own talents and opportunities in the service of those who need them. The reward or recompense will not be merely what they deserve but it will be multiplied many times.

The second revelation is in verse 161 of chapter 4, as follows:

“That they took usury, Though they were forbidden; And that they devoured Men's substance wrongfully - We have prepared for those Among them who reject Faith; A grievous punishment.”

This verse created some misunderstanding among both Muslim and non-Muslim scholars as to whether the prohibition is directed at Muslims or at the Jews. These misunderstandings occur because verse 160 deals with Jews. Hitti (1970) believed that the verse was directed at Jews in Medina. Disagreeing with Hitti's opinion, Saleh

(1986) argued that the discontentment with *riba* first occurred while the Prophet (pbuh) was still in Mecca, where there were very few Jews at that time. The second reason given by Salleh was that the Jews in Medina in those times were mostly involved in the agricultural sector and not in the commercial sector. It was the Muhajirun (Meccans who accompanied the Prophet (pbuh) in his migration to Medina) and Ansar (Medinan Muslims) who dealt with usury in Medina.

The third revelation is in the verses 130-132 of chapter 3 as follows:

“O ye who believe! Devour not Usury, Doubled and multiplied; But fear Allah; that Ye may (really) prosper.

Fear the Fire, which is prepared For those who reject faith;

And obey Allah And the Messenger; That ye may obtain mercy.”

The above verses indicate that the prohibition is for all forms and kinds of *riba*. The words ‘doubled’ and ‘multiplied’ in verse 130, however, have created some anomalies among Muslim jurists and scholars. Quttub (1906-1966) believed that the terms used are no more than a state of affairs and not a condition relevant to the imposition. Abdo (1849-1905), a jurist from Egypt, stated that it is not a condition of usury that the capital sum must multiply so as to render the one hundred to two hundred, but usury (which is increase) multiplies by repetition.

The fourth and final revelation (2:275-281) reads as follows:

“Those who devour usury Will not stand except As stands one whom The Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," But Allah hath permitted trade And forbidden usury. Those who after receiving Direction from their Lord, Desist, shall be pardoned For the past; their case Is for Allah (to judge); But those who repeat (The offence) are Companions Of the Fire; they will Abide therein (forever).

Allah will deprive Usury of all blessing, But will give increase For deeds of charity; For He loveth not Creatures ungrateful And wicked.

Those who believe, And do deeds of righteousness, And establish regular prayers And regular charity, Will have their reward With their Lord; On them shall be no fear, Nor shall they grieve.

O ye who believe! Fear Allah, and give up What remains of your demand For usury, if ye are Indeed believers.

If ye do it not, Take notice of war From Allah and His Messenger: But if ye turn back, Ye shall have Your capital sums; deal not unjustly, And ye shall not Be dealt with unjustly.

If the debtor is In difficulty, Grant him time Till it is easy For him to repay. But if ye remit it By way of charity, That is the best for you If ye only knew.

And fear the Day When ye shall be Brought back to Allah. Then shall every soul Be paid what it earned, And none shall be Dealt with unjustly.”

These final revelations severely condemned those who take *riba*. Verse 275 clearly mentions that there is a difference between trade and *riba*. While trade is permissible, *riba* is forbidden. The word ‘stand’ in this verse has two meanings. Firstly, it describes the conditions of those who associated themselves with *riba*; this attitude would cause disruption in life. Secondly, it describe the condition of those who take *riba* on the day of judgement (Ali, 1989). Verses 276 and 277 elaborate the idea that Allah will not bless those who take *riba* and will destroy property which has the element of *riba*. In this case the destruction of property may be in this world or in the hereafter. Similarly, it is claimed that those who take *riba* will be punished in both worlds.

In the subsequent verses, there is a reminder that Muslims must fear Allah and abandon the remnants of *riba* that occurred during the pre-Islamic days. The inability to comply with this instruction will bring war from Allah and His messenger. This statement serves as a serious warning to Muslims that they should not associate themselves with *riba*. They are allowed to demand from the borrowers only the principal sum with no more and no less. As instructed by verse 280, Muslims are being urged to deal justly and fairly with debtors. In the case of debtors unable to pay their debt, the lender has two alternatives. First, they should extend the repayment period and secondly, convert the loan to charity. Of the two options, verse 280 of the Koran suggests that the second is better for Muslims.

2.4.3 The Prohibition of *Riba* in *Hadith*

In line with its function as the original and eternal source of *Shariah* law, the Koran neither defines *riba* nor provides any detailed explanation of *riba*. The prohibition of *riba* is revealed in four chapters of the Koran which serves as a universal and fundamental guideline for Muslims. *Hadith* or tradition on the other hand will serve as a source of reference in order for Muslims to confirm or to acquire further explanation on the rules stipulated in the Koran (a discussion on *Hadith* as a source of *Shariah* law is given in the next chapter). The *Hadith* reports prohibition of *riba* in numerous accounts. Sometimes there are slight differences among the narrators.

Basically, *Hadith* related to *riba* can be classified into three areas, namely, directive *Hadith*, explanatory *Hadith*, and reminder *Hadith*. Directive *Hadith* is *Hadith* that prevents Muslims from dealing in any kind of *riba*. Explanatory *Hadith* is *Hadith* that explains the types and circumstances of trade that generate *riba*. Reminder *Hadith* is *Hadith* that visualises the consequences for those who associate themselves with *riba*. This classification, however, is not absolute. There is a possibility that some *Hadith*

belong to more than one classification. For example, the *Hadith* which says, “Gold for gold, silver for silver.....”, is suitable in both the directive and explanatory categories. The examples of *Hadith* relating to *riba* are shown in Appendix 3.

2.4.4 The Classification of *Riba*

There is no standardisation among early and contemporary Muslim scholars in classifying *riba*. The method of classification, however, can easily be divided based on time, origin or source of prohibitions, and lastly on the nature of the transactions that generate *riba*. One of the most popular terms used by Muslim writers in describing *riba* is ‘pre-Islamic *riba*’ or ‘*riba al-jahiliyya*’. This term describes the *riba* which was in existence prior to the introduction of Islam to Arabs. Razi (1149-1209) in his deliberation about the business practices of pre-Islamic Arabs believed that Arabs paid money monthly and left the principal amount intact. On maturity the debtors had to pay the principal amount. Therefore, in the case of inability to repay, there was the possibility that the creditor increased the principal and extended the term. This additional amount, according to Razi, is what has been called *riba* in the pre-Islamic times (Homoud, 1985). Since the *riba* during the pre-Islamic times was generated from a loan or debt it also known as ‘debt *riba*’. The source of prohibition of this *riba* is the Koran and because of this it is frequently referred to as ‘*riba* Koran’ (Ahmad, 1978).

Another type of *riba* is called ‘sales *riba*’ and the source of the prohibitions is the Prophet (pbuh). This *riba* is further divided into two categories, i.e. ‘*riba* of increase’ and ‘*riba* of delayed payment’. Increased *riba* occurs when an item subject to *riba* is sold with an addition of one consideration over the other. Delayed payment *riba* may occur in a case of the sale of an item subject to *riba* for an item of its kind. *Riba* is committed if the payment of either consideration is delayed.

'*Riba al-nasiah*' and '*riba al-fadl*' are terms frequently used by modern scholars in describing *riba*. The word '*nasiah*' comes from the root '*nasa'a*' that means 'to postpone, defer or wait'. It refers to the time that is allowed for the borrower to repay the loan after its due date. In return, the borrower must pay the additional amount or premium on the extension in duration and that additional amount is considered *riba* in Islam. Therefore, *riba al-nasiah* is the same as that which other writers call *riba al-jahiliyya*. *Riba al-nasiah* is also sometimes called '*riba al-duyun*', '*riba al-mubashir*', or '*riba al-jali*' (Al-Saud, 1992).

Riba al-fadl is *riba* which occurs as a result of trade or sale transactions. It covers all on-the-spot transactions involving cash payment and immediate delivery of the commodity. The prohibition of this kind of *riba* is by *Hadith* that says, "Gold for gold, silver for silver....." Therefore, this kind of *riba* is that which others call '*sales riba*' or '*riba al-sunnah*'. This *riba* is also sometimes known as '*riba al-buyu*', '*riba ghyr al-mubashir*', or '*riba al-khafi*' (Al-Saud, 1992).

A summary of the classification of *riba* is shown in Table 2.1. As indicated in this table, the pre-Islamic *riba* is that which originated from the extension of debt while post-Islamic *riba* originated from sales. The debt which was incurred during the pre-Islamic times could be either from business transactions or a straight loan. Ismail (1992) believed that *riba* which occurred before Islam is known as *riba al-duyun*. This *riba* is further divided into two components: *riba al-jahiliyya* and *riba al-qardah*. *Riba al-jahiliyya* according to Ismail(1992) arises when the creditor in any deferred contract of exchange, either in the *al-bai bithaman ajil* (deferred sale), *bai al-istisna* (sale on order), or *al-ijarah* (leasing), demands from the debtor an additional amount over and above that which was initially agreed to in the original contract. *Riba al-qardah* is a similar additional consideration, except that it is not an inducement for extending the period of liability arising from a contract of exchange, but rather the period of liability of a straight loan.

The pre-Islamic *riba* which was known to the Arabs has not necessarily ceased to exist in the post-Islamic period. For example, delayed payment *riba* as a result of credit sales and *riba* of a direct loan are considered as pre-Islamic *riba* even though the time of occurrence is in the post-Islamic period.

Table 2.1
Classification of *Riba*

	Pre-Islamic <i>Riba</i>	Post-Islamic <i>Riba</i>
Source of Prohibition	<i>Koran</i>	<i>Hadith</i>
Area of Emergence	Extension of Debt	Point of Sales: Increase in countervalues Delay in payment
Common Terminology	Debt <i>riba</i> <i>Riba Koran</i> <i>Riba al-jahiliyya</i> <i>Riba al-nasihah</i> <i>Riba al-duyun</i> <i>Riba al-mubashir</i> <i>Riba al-jali</i>	Sales <i>riba</i> <i>Riba al-Hadith</i> <i>Riba al-sunnah</i> <i>Riba al-fadl</i> <i>Riba al-buyu</i> <i>Riba ghyr al-mubashir</i> <i>Riba al-khafi</i>

2.4.5 *Riba* Among the Muslims

The controversies among Muslims concerning *riba* can be traced back to the early days of Islam. During the early years of Islam, the conflicts were concentrated within the context of its scope and legality. There are some differences among the four schools of law (*mazahab*) with regard to the scope of the ban on *riba*, the transactions that constitute *riba*, and the types of properties subjected to *riba* (the views of the four *mazahab* on *riba* are given in Appendix 4).

Just as in the sales *riba*, debt *riba* has also created controversies among early as well as contemporary Muslim scholars. The centre of controversy was the lawfulness of repaying the loan with interest or premium added. According to Saleh (1986), the majority of these scholars believed that every loan that produced an advantage is *riba*.

This is in line with the *Hadith* in which the Prophet (pbuh) said that every loan entailing benefit is usury. *Riba*, however, is not committed in the case of an additional amount paid by the debtor over the principal sum if there is no customary agreement involved. This is in line with *Hadith* narrated by Abu Huraira (600-678) in which the Prophet (peace be upon him) commended Muslims who repay their loans in the best manner (Homoud, 1985).

Homoud (1985) claimed that many contemporary Muslim scholars believed that Abdo (1849-1905), a Mufti of Egypt, was one of earliest modern scholars who had given a contradictory opinion pertaining to *riba*. The allegation against Abdo was based on his *fatwa* or ruling which was published in the *Al Manar* (an Egyptian-based magazine). In its December 1903 issue, *Al Manar* published the following statement by Abdo:

“The stipulated usury is not permissible in any case, whereas the Post Office invests the monies taken from the people, which are not taken as loans based on need, it would be possible to apply the investment of such monies on the rules of partnership in commendam.”

(Homoud, 1985, p. 122)

Ridha (1865-1935), a student of Abdo, denied that his teacher had issued such a ruling but confirmed that certain Government officials including the Director of Posts had a private discussion with Abdo on this matter. On many occasions Ridha also expressed his opinion in matters relating to *riba*. One of the most controversial statements issued by him is that in which he said it is permissible for a person to borrow Lira 100 and sign a note for Lira 120 and this practice is not absolute usury. According to Ridha the deferred payment *riba* takes place only with the extension of debt upon maturity.

Dawalibi, a contemporary Syrian politician and journalist, is one of the Muslim scholars who argued that reasonable interest should be allowed for loans of production. During the Scientific Conference of Islamic Jurisprudence which was held in Paris in 1951, he said:

“The banned usury takes place in loans meant for consumption not for production, wherein the former sector the usurers take advantage of the need of the poor and destitute to exhaust them with exorbitant usury they impose on them. Nowadays, as the economic systems have been developed and many companies have been established, where most of the loans are being granted for production not for consumption, it is necessary to consider what development must be introduced to the stipulations in consequence of this development of civilization.”

(Homoud, 1985, p.120)

The discussion on the legality of *riba* during modern times is supposed to be sealed off by the resolution passed by the conference organised by the Islamic Research College of the University of Al Azhar, Egypt, in 1965. During the conference, a recommendation that reaffirmed explicitly that interest on all kinds of loans is illegitimate *riba*, and that much or little usury is also illegitimate, was passed by the participants and was to be followed by all Muslim scholars.

The resolution, however, failed to prevent other Muslim scholars from giving their contradictory opinions. Zakaria (1989), for instance, agreed with the definition of *riba* given by Ali (1872-1948). Ali, one of the leading contemporary Muslim scholars, was reported as saying:

“Our *ulama* (Muslim learned scholars) both ancient and modern, have worked out a great body of literature on *riba*, based mainly on economic conditions as they existed at the rise of Islam. I agree with them on the main principles, but respectfully differ from them on the definition of *riba*. The definition I would

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

(Zakaria, 1989, p.41)

The most recent view pertaining to *riba* is given by Al-Saud (1992) who believed that *riba al-fadl* is lawful. Al-Saud defined *riba al-fadl* as any arrangement where an immediate exchange of goods of the same kind takes place when one person receives from the other something more in quantity than what he had given. Since the transaction is merely an exchange or barter, it cannot be regarded as such except when there is a difference between the things exchanged. He also claimed that in the case of barter that involved goods of different quality, it was reasonable to expect that the number of goods of the lower quality was more than of the superior quality. Therefore in this case the exchange process was lawful and permissible. This opinion is also in line with the opinion given by one of the early Muslim scholars, Hazm (994-1064), but contrary to the opinion of Qayyim (1292-1350).

2.5 Sources and Uses of Funds

Like conventional commercial banks, Islamic banks are dependent on the depositors' money as a major source of funds. For conventional banks, deposit facilities cater to various motives for holding money. Following the Keynesian approach, people require money for three purposes: transaction, precaution and investment. Conventional banks, therefore, provide three types of deposit facilities in accordance with these requirements. The first category of a deposit facility is called a current account which is sometimes known as a checking account. This facility is designed for those who require money for transaction purposes. The motives of the depositors in this category are only convenience or payments of daily commitments. Usually no

interest is paid by the bank to current account holders. This practice, however, is changing among the conventional banks. In fact, commercial banks in some countries (e.g. Malaysia) charge for unavoidable costs, such as the cost of a cheque book and stamp duty, and also impose a moderate service fee on current accounts.

In the absence of interest, Islamic banks are permitted by *Shariah* to offer facilities that are similar to the current account facilities of the conventional banks. Depositors are allowed to withdraw their funds at any time without notice and Islamic banks guarantee the nominal value of the deposits. Principles of *qard hassan*, or *wadiah*, are adopted by the Islamic banks in dealing with current account facilities. Details of these principles are presented in Chapter 3.

The second category of deposit is the savings account. For conventional banks, this account services those who wish to save money and at the same time earn income. The depositors in this category are those who hold money primarily because of precautionary motives and, at the same time, are induced by the investment motive. Principles of *wadiah*, *mudaraba*, and *qard hassan* are the alternatives available for the Islamic banks which choose to offer this kind of facility.

The third category of deposit facility is for those who keep money for investment reasons. Customers who have idle funds usually want better returns on their funds. These customers normally prefer to keep their money in a fixed (or term) deposit facility. In the Islamic banking system, a similar facility is called 'investment deposit'. This deposit is governed by the principle of *mudaraba*. Within this context, Islamic banks act as agent-manager or *mudarib* and the depositor as investor or *rabb al-mal*. There are a few alternatives available within this type of deposit. The bank would provide no guarantee or fixed return on the amount deposited. Customers who hold their funds in this investment deposit will be treated as if they were shareholders of the bank and are entitled to a share of the profits or losses made by the bank.

Agreement on how the profit or loss will be distributed between the bank and the depositor is reached at the beginning of the deposit period and cannot be amended during the tenure of the deposits, except by the consent of both parties. The distribution of profit to the depositors may be on a quarterly, half-yearly, or yearly basis and advance notice is required for those who wish to withdraw their funds before the maturity date. The *Shariah* also permits Islamic banks to raise funds by way of issuing investment certificates that carry no fixed return. These certificates are issued either directly to the depositors or through the Islamic inter-bank money market. The tenure of these certificates would vary from one to five years or even more. The principles of *mudaraba* and *qard hassan* are applicable for this kind of facility. In applying the principle of *mudaraba*, the reward for the depositors is based on the bank's annual profit, whereas, under the principle of *qard hassan*, the reward is entirely dependent upon the bank's discretion.

As entities which have been established on religious foundations, Islamic banks are expected to abide by whatever rules and regulations are imposed by the Koran and *Hadith*. Islamic banks are not guided by profit maximising goals. Their utmost objective is the betterment of the *ummah* (community) and their overall business philosophy is based on justice and equity. Because of this philosophy, Islamic banks, subject to the availability of its funds, participate in both new or existing projects as long as the proposed venture is viable and profitable.

Non-commodity trading is strictly prohibited by the *Shariah*. Since the *Shariah* considers money as a non-commodity item, granting loans to customers for profit is therefore unlawful (Siddiqi,1986). In most cases the funds will be used through equity participation or partnership. Principles of *mudaraba*, *musharaka*, and *murabaha* are commonly applied by Islamic banks in assisting their commercial customers. Principles of *ijara* and *ijara wa-iktina* are used for hire-purchase and leasing facilities. The principle of *qard hassan* is for ordinary customers who need

financial assistance in buying durable goods and other personal needs. Other banking services such as letters of guarantee, letters of credit, remittance services, travellers cheques, and safe deposit boxes are provided as fee-based services.

2.6 Relationship with the Suppliers and Users of Funds

The status of the relationship between Islamic banks and their suppliers and users of funds is dependent on the principles of *Shariah* used in creating that relationship. In most cases, the status of the relationship with the suppliers of funds includes that of trustee and beneficiary, debtor and creditor, investor and entrepreneur, and partner and partner. On the other hand, the relationship with the users of funds comprises debtor and creditor, investor and entrepreneur, partner and partner, principal and agent, and trader and customer.

Theoretically, the relationship between Islamic banks and the suppliers and users of funds is bound together by three general principles which dominate the economic behaviour of Muslims. These principles comprise the belief in the Day of Judgement and the life in the hereafter, the Islamic concept of riches, and the Islamic concept of success (Khaf, 1980). All these principles are expected not only to have a significant impact on the decision-making process of Muslims, but also to have an influence on their perceptions of Islamic banks.

2.6.1 Suppliers' View

The first principle has an effect on the suppliers' (depositors') behaviour and their decision-making process. The choice of action is based not only on the immediate returns but also on those in the hereafter. Therefore, the decision to have a banking relationship with Islamic banks is not based on a profit motive but rather to gain the

blessing of Allah. One of the ways to gain blessings is to support any program that will improve Muslim communities. Verse 20 of chapter 9 of the Koran states:

“Those who believe, and suffer Exile and strive with might and main, in Allah's cause, With their goods and their persons, have the highest rank In the sight of Allah: They are the people Who will achieve (salvation).”

Since Islamic banks operate on an interest-free basis and their establishment is designed to improve Muslim communities, Muslims who support these banks are therefore considered people who will achieve salvation as indicated by the above verse.

In the case of the second principle which involves wealth, Islam has given a clear guideline to be followed by Muslims. In Islam, wealth is a bounty from Allah and is a tool that may be used for good or for evil. Poverty is, in some instances, associated with disbelief and riches are considered a gift from Allah (Khaf, 1980). Wealth itself is considered as an important means by which man can pave the way for the attainment of his ultimate objective. All persons are exhorted to work to earn a living and to accumulate wealth, and no one who is physically and mentally able is allowed to become a liability to his family. Accumulating wealth is considered among the highest blessings bestowed on man and everyone is encouraged to strive for wealth. Verse 10 of chapter 62 of the Koran states:

“And when the Prayer Is finished, then may ye Disperse through the land, And seek of the Bounty Of Allah: and celebrate The Praises of Allah Often (and without stint): That ye may prosper.”

This verse suggests that Muslims work and acquire wealth upon completion of prayer. The methods of earning, possessing, and disposing of wealth are defined by the *Shariah*.

The best method of accumulating wealth as defined by *Shariah* is by striving on one's own and not from the income generated by other peoples' efforts. This is in line with many *Hadith* in which the Prophet (pbuh) had given his advice to Muslim followers to work for their own food. For example, the Prophet (pbuh) is reported to have said:

“Nobody has ever eaten a better meal than that which one has earned by working with one's own hands. The Prophet of Allah, David, used to eat from the earnings of his manual labour.”

(Khan, 1986, pp. 162-3)

The Islamic concept of riches also serves as an important factor which influences Muslim attitudes toward the existence of Islamic banks. Islam defines success as the level of obedience to Allah and not the accumulation of wealth. Service and obedience may be rendered by the positive use of capabilities and resources given by Allah. According to Islamic teachings, if a man really wants to serve Allah, the utilisation of the natural and human resources made available to him is not only a privilege but also a duty and obligation prescribed by Allah. This is in line with verse 27 of chapter 8 of the Koran which commands Muslims not to betray the trust given by Allah and His Apostle. Applying this principle to the banker-customer relationship would mean that the customer should not be discouraged by low profits or limited success of banks.

In the light of these three principles, Islamic bank customers are expected not to be guided by the profit motive. Instead, the reason for placing their monies with the Islamic banks is focussed more towards getting a blessing from Allah and this action is considered the best way of managing the resources given by Allah. Since it is a belief of every Muslim that all properties belong to Allah, returns on their deposits are also considered a gift from Allah irrespective of amount. Similarly, in the case of loss, it is all from Allah.

2.6.2 Users' View

Similarly, the users of funds should not regard Islamic banks as institutions with a profit motive, nor as a charity organisation. Instead, they should perceive Islamic banks as a vehicle for promoting and developing the Islamic community. Although Islamic banks are responsible for assisting those who are in need, whether they are customers or not, such assistance will be given in the most appropriate manner. This is because Islamic banks have responsibilities not only to those in need but also to the suppliers of funds and the whole community.

Islamic banks, however, are expected to be more supportive towards their customers. Customers who are facing difficulties in meeting loan repayments will not be treated harshly. This is in line with verse 280 of chapter 2 of the Koran which says:

“If a debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is the best for you if ye only knew.”

The customers who receive financial assistance from Islamic banks are expected to discharge their liability accordingly. This is in line with verse 1 of chapter 5 of the Koran which says:

“O ye who believe ! Fulfil (all) obligation....”

In relation to entrepreneurs, Islamic banks are expected to be more receptive and proactive in the process of creating, moulding and developing entrepreneurs. The principle of *mudaraba*, for example, serves as an impetus for creating new entrepreneurs. Those who possess business skills and ideas but who are without capital can turn to Islamic banks for financing. This mode of financing also encourages existing entrepreneurs to undertake projects that involve high risk but are also highly profitable and productive. Entrepreneurs who are enjoying the *mudaraba*

mode of financing will benefit in two ways. Firstly, they need not worry about repayment. Islamic banks will only get their share from the ex-post profit. In the case of losses, entrepreneurs only go unrewarded for their time and effort. The risk of losses will be completely borne by the bank. Secondly, as a partner, Islamic banks will extend their full support morally and financially in order to make sure that the profit figure is attainable.

As a result of an ongoing relationship with Islamic banks the customer tends to become more religious and ethical. Islamic banks are in the best position to mould their partners toward religious and ethical entrepreneurship and this is effectively done in two ways. Firstly, as an investor the Islamic bank is guided by *Shariah* and funds can only be invested in productive and permissible investments. The Koran declares that the following forms of investments are unlawful:

1. trades that promote obscenity;
2. prostitution and adultery;
3. manufacture, sale and transportation of liquor;
4. making and sale of idols and services rendered in or to pagan places of worship;
5. fortune-telling and drawing lots;
6. business which involves usury.

Secondly, Islam has prescribed some principles concerning trade and commerce which must be followed. At any time, transactions must be conducted honestly, faithfully and beneficially. The Koran also outlines unlawful conduct. Conduct such as bribery, misappropriation, embezzlement of public or private wealth, larceny, unfair use of the property of an orphan, gambling, and short weight and measure is prohibited by Islam.

Chapter 3

ISLAMIC BANKING LAWS AND REGULATIONS

3.1 Introduction

Islamic banks are expected to conform to two types of laws. As normal business entities, Islamic banks are governed by laws and regulations imposed by the government of their domiciled country. These laws are commonly known as positive laws. As institutions whose foundations are based on Islamic doctrines, Islamic banks must also operate within the ambit of Islamic principles and laws. Without observing and following the foundations and rules as stipulated in the various sources of Islamic laws, no institution can claim to be Islamic. Islamic laws are also known as *Shariah* laws.

Positive laws or the laws that are given by a person of authority are distinct from moral and sacred laws given by God or with God's guidance. The term 'positive laws' refers to Western laws and also secular statutes borrowed by Islamic countries. In Malaysia, for example, the establishment of Islamic banking is governed by The Companies Act (1965), and its operations are subjected to The Islamic Banking Act (1983). Islamic banks, therefore, must conform to all requirements as stipulated in both Acts. Similarly, other governments have passed special laws that govern the operations of Islamic banks in their country.

Schacht (1964), a contemporary historian in Islamic civilisation, mentioned that Islamic law is an all-embracing body of religious duties, the totality of Allah's commands that regulate the life of every Muslim in all its aspects. It comprises on an equal footing ordinances regarding worship and ritual, as well as political and (in a narrow sense) legal rules. He believed that Islamic law was created not by an irrational process of continuous revelation but by a rational method of interpretation. Schacht also claimed that both religious standards and moral values which were introduced into the legal subject-matter provide the framework for a structural order.

Maududi (1983) argued that the main objectives of *Shariah* are to construct human life on the basis of *marufat* (virtues) and to cleanse it of the *munkarat* (vices). The term *marufat* denotes all the virtues and good qualities that have been accepted as 'good' by human conscience. Conversely, *munkarat* denotes all the sins and evils that have been condemned by human nature as 'evil'. In short, the *marufat* are in harmony with human nature and its requirements in general and the *munkarat* are just the opposite. The *Shariah* gives a clear view of these *marufat* and *munkarat* and stresses these as the norms to which individuals and social behaviour must conform.

Besides highlighting the meaning of *Shariah*, this chapter will also elaborate on the sources of *Shariah* and its applicability to the Islamic banking system. The principles of *Shariah* which govern the operation of Islamic banks will also be discussed. Finally, this chapter will elaborate on the intervention by monetary authorities especially the Central Banks, in monitoring and supervising Islamic banks.

3.2 The Meaning and Concept of *Shariah*

The original meaning of the word *Shariah* or *shar* is 'the path or the road leading to the water' and the verb *shara'a* literally means 'to chalk out or mark out a clear road to water.' In a religious usage, it means 'the highway of good life.' In other words, *Shariah* is the way which directs man's life to the right path (Rahman, 1979). From the words 'the right path', therefore, came the meaning 'law' (Denny, 1985). The word *Shariah* also has its correlation with the word *din* which literally means 'submission' or 'following'. *Shariah* is the ordaining of the Way and its proper subject is God, whereas *din* is the following of that Way and its subject is man. Thus, as far as Koranic idioms go, one may speak of *Shariah* and *din* interchangeably (Rahman, 1979).

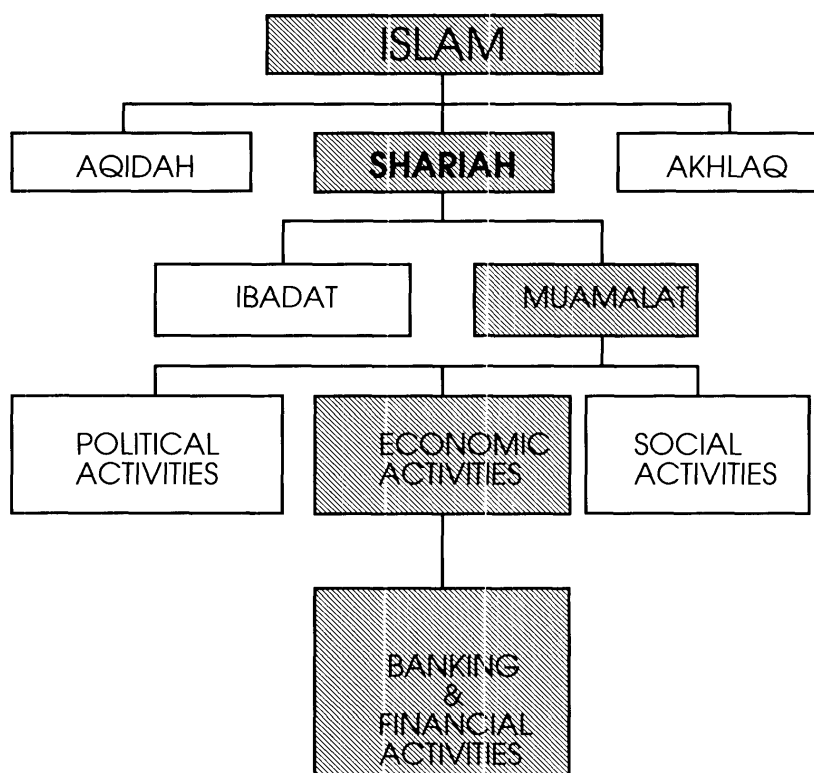
The concept of *Shariah* is not only to govern man in the conduct of his life in order to realise the Divine Will, but covers all behaviour - spiritual, mental and physical. Therefore, *Shariah* principles are more than law, covering the total way of life that includes both faith and practices, personal behaviour, and legal and social transactions. In other words, *Shariah* is a comprehensive set of principles establishing a total way of life.

Ismail (1992), in his elaboration on the root of Islamic banking and finance, perceived Islam as comprising three basic elements, namely, *Aqidah*, *Shariah*, and *Akhlaq*. *Aqidah* concerns all aspects of faith and belief of a Muslim in Allah and His will. *Shariah* is concerned with all forms of practical actions by a Muslim manifesting his faith and belief, and finally *Akhlaq* covers all aspects of a Muslim's behaviour, attitude and work ethics with which he perform his practical actions. Aspects of *Shariah* can be further divided into two areas, namely *Ibadat* and *Muamalat*. *Ibadat* is concerned with the practicalities of a Muslim's worship of Allah, whereas *Muamalat* is concerned with the man-to-man relationship. Nevertheless, aspects such

as political activities, economic activities and social activities will be within the ambit of *Muamalat*. The Islamic banking system, therefore, being part of economic activity, is linked to *Shariah* principles through *Muamalat*. The linkages between Islamic banking and the total aspect of Islam is shown in Figure 3.1.

Figure 3.1

The Relationship between the Islamic Banking System and Islam



Source: Ismail (1992), p. 250.

Ali (1950), nevertheless, divided Islam into two parts, namely, the theoretical and the practical. The theoretical aspects of Islam cover articles of faith or its doctrines and these aspects are known as *usul* (sing. *asl* which means a root or a principle). The practical aspects include all that a Muslim is required to do or, in other words, the practical course which he must follow. These practical aspects are known as *faru'* (sing. *far'* which means a branch). The theoretical aspects are also called *aqa'id* (pl.

of *aqidah*, lit. *what one is bound to*) or beliefs, while the practical aspects are also called *ahkam* (pl. of *hukm*, lit. *an order*) or ordinances and regulations of Islam. The existence of Islamic banking is therefore governed by the practical aspects of Islam and must conform to the *ahkam* of Islam. There are five categories of *ahkam* or principles in *Shariah* law as described below.

1. *Fard* or *wajib*: Compulsory duties and acts to be performed by all Muslims. Performance is rewarded and omission is punished.
2. *Sunna*, *masnun*, *mandub*, or *mustahabb*: Duties and acts that are recommended but not required. Performance of them is rewarded, but omission is not punished.
3. *Ja'iz* or *mubah*: Indifferent actions, whose performance or omission is neither rewarded nor punishable.
4. *Makruh*: Actions that are disapproved but not punished or forbidden.
5. *Haram*: Actions that are both forbidden and punished.

Riba, for instance, falls in the category of *haram* and is punishable.

3.3 Sources of *Shariah* Law

Basically, there are four fundamental sources of *Shariah* law. The first source is the Islamic Holy Book called Koran. The Holy Koran is the original and eternal source of *Shariah* law. It constitutes messages that *Allah* presented to the Prophet (pbuh) for the guidance of mankind. These messages are universal, eternal, and fundamental. The *Hadith*, the second foundation of *Shariah*, is next in importance to the Koran. It refers to information, accounts, narratives, stories and records of the *Sunnah* of the Prophet (pbuh). These were handed down from generation to generation to become the rule of

faith and practice of Muslims. The *Sunnah* (pl. *sunan*) signifies the customs, habits and usages of the Prophet (pbuh). It describes the Prophet's (pbuh) behaviour, modes of action, his sayings and declarations under a variety of circumstances in life. The third source of *Shariah* law is the *Ijma*. *Ijma* means a consensus of opinion of *mujtahids* (learned scholars of Islam or those authorised to exercise independent legal reasoning), or an agreement of Muslim jurists of a particular age on a question of law. The fourth and last source of *Shariah* is the *Qiyas* which literally means 'measuring by' or 'comparing with' (Ali, 1950). *Qiyas* is the process of reasoning by analogy of the *mujtahids* with regard to difficult and doubtful questions of doctrine or practice, by comparing them with similar cases already settled by the authority of the Koran and *Sunna* and thus arriving at solutions of undecided questions (Klein, 1985).

Both the Koran and the *Sunnah* are called *al-adillat-al-qatiyyah* meaning absolutely certain arguments or infallible proof. This is because these sources contain absolute truth and undoubted fundamental doctrines of Islam. The *Ijma* and *Qiyas* on the other hand are called *al-adillat-al-ijtihadiyyah* or arguments obtained by exertion. The former are also known as *usul* or the roots, whereas the latter are the *puruq* or the branches. Within these four frameworks, *Shariah* law is able to deal with the complexity of today's dynamic world and is capable of handling various conflicting problems of modern life.

Besides these four main sources of *Shariah*, there are other minor sources such as *ijtihad* (to strive to the utmost), *ma'ruf* (well known or customary), *maslahat* (general good or welfare), and *istihsan* or *istislah* (public interest). The usage of these sources however is often limited to certain schools of law. Sometimes these concepts are incorporated within the principles of *ijma* and *qiyas*.

3.3.1 Koran

The Koran is the foundation of Islam and is primarily a book of religious and moral principles. It consists of 114 chapters of unequal length called *sura* (sing. *surat*) which literally means 'eminence' or 'high degree' and each chapter has a special title. These chapters are further divided into verses called *ayah* (sing. *ayat*) which means 'sign' or 'communication from God.' Without taking the 113 words of its opening verse (*Bismillah*) into consideration, the total number of verses is 6,240 (Ali, 1950). According to Doi (1984) the Koran contains 86,430 words, 323,760 letters of the alphabet and 6,666 verses. The Koran also specifies as to whom, when, in what language, how, and why it was revealed. The Koran was revealed to the Prophet (pbuh) through a process called '*wahy matluww*' or 'revelation that is recited'. In this case, Gabriel or the Holy Spirit who acted as an intermediary gave directly to the Prophet (pbuh) divine messages from Allah

Basically, chapters in the Koran are divided according to the place of revelation. Chapters revealed in Mecca are called the Mecca chapters and those revealed in Medina are called the Medina chapters. There are 92 Meccan chapters and the remainder were revealed during the Medina period (Ali, 1950).

There are three broad features which distinguish the two revelations. Firstly, the Mecca revelation deals chiefly with faith in God and is particularly devoted to grounding Muslims in the faith, while the Medina revelation is chiefly intended to translate that faith into action. The second feature distinguishing the two revelations is that the Mecca chapters are generally prophetic, while those from Medina deal with the fulfilment of prophecy. Lastly, while the Mecca revelation shows how true happiness of mind may be sought in communion with God, the Medina verses point out how man's dealing with man may also be a source of bliss and comfort to him.

3.3.2 *Hadith*

Hadith literally means a story, a narration or a report (Rahman, 1979). It also has root meanings of 'being new' and 'occurring, taking place, coming to pass' and extends to talking about or reporting what has happened. Therefore, *Hadith* is a report of something that had taken place. This report or saying is conveyed to another party either through hearing or through revelation. *Hadith* is also known as 'tradition' because it was passed down from person to person and from generation to generation. In *Shariah*, *Hadith* describes the *sunnah* (the way or manner) of the Prophet (pbuh).

Sunnah literally means a way or rule or manner of acting or mode of life (Ali, 1950). The Koran also mentions the word *sunnah* which in a general sense means a way or rule. Rahman (1979) described the word *sunnah* as 'a trodden path', and each section of the path is considered as a *sunnah* regardless of its position, whether near to the starting point or remote from it. There are three kinds of *sunnah* (Ali, 1950):

- a. A *qul* or a 'saying' of the Prophet (pbuh) which has a bearing on a religious question.
- b. A *fi'l* which represents an action or practice of the Prophet (pbuh).
- c. A *taqrir*, the Prophet's (pbuh) silent approval of the action or practice of another.

Hadith is the second and undoubted source from which the *Shariah* laws are drawn. This is in line with various verses in the Koran which commanded the believers to obey Allah and his Apostle (3:32; 4:59; and 59:7). As a source of *Shariah* law, *Hadith* in many cases confirmed, extended, elaborated, explained, and complemented the revelation.

As far as the *Shariah* is concerned, not all *Hadith* can be used as a source in formulating the law. *Hadith* in the category of *sahih* (sound) are the primary source of *Shariah* law. The second category of *Hadith* is called *hasan* (fair) and *Hadith* in this category are not considered very strong, but they are necessary for establishing a point of law. Indeed, most of the *Hadith* concerning legal matters are of this type. The last category of *Hadith* is *da'if* (weak) or *sakim* (infirm). *Hadith* which fall into this category deal with matters of law or with things which are allowable or forbidden will not be used as a source of *Shariah*. The usage is considered appropriate only if it deals with exhortations, stories, and good behaviour.

3.3.3 *Ijma*

Ijma, or consensus, was originally the agreement of qualified legal scholars in a given generation and such a consensus of opinion is deemed infallible. The emergence of this concept as a source of law is in line with one *Hadith* which says, "My community will never agree upon an error." This statement denotes the universal acceptance by all Muslims of the fundamental tenets of the faith, such as belief in the mission of the Prophet (pbuh) and the divine nature of the Koran. In its broadest sense, of course, *Ijma* is not the criterion of authority at all but simply the collected expression of a common religious conviction. *Ijma* was regarded as absolutely authoritative not only for discerning the right at present and in the future, but also in the past: it was *Ijma* that determined what the *sunnah* of the Prophet (pbuh) had been and indeed what was the right interpretation of the Koran. In the final analysis, therefore, both Koran and *Hadith* were authenticated through *Ijma* (Rahman, 1979).

The *Ijma* among the Muslim community is arrived at by *ijtihad* or exertion, or conscientious examination and meditation on the subject under consideration. Such consensus or agreement is generally said to be threefold:

- a. Agreement of word or declaration of opinion in words.
- b. Agreement of act, practice or expressed in unanimity of action or practice.
- c. Agreement of silence or tacit assent by silence or by non-interference.

Mujtahids (learned scholars) who are involved in this process must be men of integrity and honesty. Their minds must not be iniquitous (*fasik*) or blinded by passion (*hawa*) which inspires pernicious doctrines. There are three classes of *mujtahids* for this task, namely, the absolute *mujtahid* who has absolute authority and whose sphere of exertion embraces the whole law, the *mujtahid* of a special school of theology who is an authority within the sphere of one of the special theological systems (*madzhab*) and, lastly, *mujtahid* of special questions and cases which have not been decided by the founders of the four schools of laws (Klein, 1985).

3.3.4 *Qiyas*

The fourth source of *Shariah* is the *Qiyas*, which means literally ‘measuring by’ or ‘comparing with’, or ‘judging by comparison’ (Ali, 1950). Briefly it may be described as reasoning by analogy of *mujtahids*. Reasoning or the exercise of judgment, in theological as well as in legal matters, plays a vital part in Islam and the Koran clearly recognised this process. Verse 83 of chapter 4 states:

“When there comes to them Some matter touching (Public) safety or fear,
They divulge it. If they had only referred it To the Messenger or to those
Charged with authority Among them, the proper Investigators would have
Tested it from them (direct). Were it not for the Grace And mercy of Allah
unto you, All but a few of you Would have followed Satan.”

In Islam, those who do not use their reasoning faculty are compared to animals, and are spoken as being deaf, dumb and blind (2:171; 7:179; 8:22; and 25:44). While

those who do not exercise their reason or judgment are condemned, those who understand tend to be praised (190:3). The Prophet himself is reported to have sanctioned and encouraged reasoning and the exerting of the faculties of one's mind, in order to find proper solutions for difficult and doubtful cases of law.

3.4 *Shariah* Laws in the Islamic Banking System

As stated earlier, the objective of *Shariah* is to construct life on the basis of virtues and to cleanse it of vices. *Shariah* is therefore expected to provide not only the right path but also to govern all activities of Muslims toward the betterment of the whole community, activities which will be fully rewarded in the next life. In reality, however, instead of being governed by the *Shariah*, Muslims are constantly bound by customary and positive laws. This situation which prevails in modern times commenced during the medieval age of Islam when the *Shariah* was frequently set aside by orders of the Caliph and governors, especially in matters related to commerce and civil order (Guillaume, 1977).

The emergence of an Islamic banking in the 1960s and 1970s served as an impetus for the reestablishing of *Shariah* law in commercial activities. This was largely because banking laws in all Muslim countries were the conventional banking laws or interest-based laws. But then interest is prohibited by the Koran and the *Hadith*. In order to allow Islamic banks to operate, governments of Muslim countries such as Pakistan and Malaysia commissioned Muslim jurists to promulgate laws which were applicable to this new style of banking. A similar approach was also taken at the international level. In December 1970, the second conference of Foreign Ministers of Islamic Countries commissioned a group of experts from 18 member countries to study the proposal to establish an International Islamic Bank for Trade and Development (Ali, 1988). This group in their submission detailed the objectives and functions of the

proposed institution, and also recommended the establishment of a consultative body in the field of Islamic banking and economics.

In the process of reestablishing *Shariah* law in banking, it was inevitable for Muslim jurists to refer to the primary source of *Shariah*, i.e. the Koran and *Hadith*. The Koran, however, being primarily a book of religious and moral principles and exhortations, is not a legal document. It nevertheless does embody important legal enunciations (Mannan,1986). Khallaf (circa1900) has made the following classification of legal provisions found in the Koran (Zakaria, 1989):

1.	Source of law	: 50 verses
2.	Constitutional provisions	: 10 verses
3.	International law	: 25 verses
4.	Jurisdiction and procedures	: 13 verses
5.	Penal law	: 30 verses
6.	Civil law	: 70 verses
7.	Family and personal law	: 70 verses
8.	Economic and financial directives	: 20 verses

In regard to Islamic banking, the Koran has given clear and explicit guidelines that such operations should be free from any element of interest. As an ordinary business entity, the Islamic bank is expected to conform to the rules and guidelines given by the Koran. For example, Islamic banks are required by the Koran to fulfil their obligations to their shareholders, depositors, partners, borrowers and other customers (2:177; 5:1; 16:91; 17:34). Islamic banks are expected to uphold trust, justice, and fairness in their dealings (4:58; 4:135; 5:8; 5:87; 6:152; 16:90; 17:35; 23:8; 55: 8&9; 70: 32&33). The Koran also provides guidelines for Islamic banks when dealing with those who borrow money from them (2:280 and 3:75). In terms of business procedures, the Koran also prescribes details regarding the prosecution of contracts, and other covenants involved in the contract (2:282-283). Islamic banks are

prohibited from investing in or having any dealings with unproductive businesses (2:188) or businesses which promote obscenity, or which involve the manufacturing, selling and transporting of liquor, the making and selling of idols and services rendered in or to pagan places of worship, fortune-telling and drawing lots, and businesses that involve usury and bribery (2:188; 2: 275-280; 3:130; 5:42; 5:90; 24:19) (Siddiqi, 1986).

There are also many *Hadith* especially in the category of *sahih* which are very relevant and serve as guidelines to Islamic banking. Of foremost importance are *Hadith* that prevent Muslims from associating themselves with the element of *riba*. Besides that, there are many other *Hadith* in the area of sales, *as-salam* (sale in which a price is paid for goods to be delivered later), renting, *al-hawala* (transfer of a debt from one person to another), representation, lending, payment of loans, freezing of property, bankruptcy, partnership, mortgaging, witnesses, and conditions of transactions. These *Hadiths* are consequently an important source of reference for Islamic banks in their daily operations.

Currently, there is no Muslim country which has succeeded in formulating and implementing a complete package of *Shariah* law which covers all aspects of life. Likewise, Islamic banking laws are not comprehensive. In most cases the law is similar to conventional banking law except with an additional clause that prohibits the banks from dealing with interest (Section 3.6 elaborates further on this point). In the absence of well documented *Shariah* laws with regard to commercial transactions, Mahmasani (1982) believed that the concept of *Ijma* and *Qiyas* has become even more important in formulating new *Shariah* laws. These new laws are, however, confined to the field of *muamalat* (relationship between man and man) which includes commercial transactions, but have no value to *ibadat* or *i'tikadat* (worship).

3.5 Principles of *Shariah* in Islamic Banking

Muslim jurists and scholars have suggested a number of *Shariah* principles to be adopted by Islamic banks in delivering their products and services. Among the most widely used *Shariah* principles recommended by these scholars are *mudaraba*, *musharaka*, *murabaha*, *bai-mua'zzal*, *ijara*, *ijara wa-iktina*, *qard hassan*, *wadiah*, and *rahn*. Basically these principles can be broadly classified into four categories as set out below:

i. Profit and loss sharing principles

a. *Mudaraba*

b. *Musharaka*

ii. Fee or charge based principles

a. *Murabaha*

b. *Bai mu'azzal*

c. *Ijara*

d. *Ijara wa-iktina*

iii. Free service principle

a. *Qard hassan*

iv. Ancillary principles

a. *Wadiah*

b. *Rahn*

Besides these principles, there are other isolated principles applicable to Islamic banking but the usage of these principles is limited to specific Muslim countries (a detailed explanation is provided in the next chapter). A brief explanation of the most widely used *Shariah* principles is as follows.

Mudaraba

Mudaraba means ‘profit-sharing’ or ‘trust finance’ or ‘investment through self-employed entrepreneur’. This is basically an agreement between at least two parties, one being a lender (sometimes known as an investor) and the other being an entrepreneur (also known as an agent-manager). In the agreement, the investor agrees to finance or entrust money to the entrepreneur who is to trade in an agreed manner and then return to the investor the principal and pre-agreed proportion of profits and keep for himself the remainder. The distribution of profit between the two parties must necessarily be on a proportional basis and cannot be a lump sum or a guaranteed amount. In the case of loss as a result of circumstances beyond the control of the entrepreneur, the investor will bear all financial risk and the entrepreneur loses the time and his efforts only.

Musharaka

Musharaka is normally translated into English as ‘partnership’. In the context of Islamic banking, however, *musharaka* means ‘participating financing’. Literally, *musharaka* means a joint-venture agreement between two parties to engage in a specific business activity with the aim of making a profit. The termination of the agreement may be based on time or after fulfilment of certain conditions. In this principle, both parties will provide the capital and the investor or lender may also participate in the management. As in the case of *mudaraba*, all parties agree through negotiation on the ratio of distribution of profits generated from the business activity which need not coincide with the ratio of participation in the financing of the activity. However, in the event of loss, all parties bear the loss in proportion to their share in the financing.

Murabaha

Murabaha or ‘cost-plus financing’ or ‘financing resale of goods’ refers basically to the sale of goods at a price covering the purchase price plus a profit margin agreed upon by both parties concerned. This arrangement transforms a traditional lending activity into a sale and purchase agreement, under which the lender buys goods wanted by the borrower for resale to the borrower at a higher price agreed

upon by both parties. In this principle, Islamic banks play the same role as any other business entity, i.e. giving services or selling goods to customers with the aim of making profit.

Bai Mua'zzal

Bai-mua'zzal or 'deferred payment sale' is a variant concept of *murabaha* and in this case the borrower is allowed to defer settlement of payment for goods purchased within the period, and in a manner determined and agreed by both parties.

Ijara

This is the *Shariah's* concept of leasing finance, whereby the bank purchases the asset required by the customer, and then leases the asset to the customer for a given period, the lease rental and other terms and conditions having been agreed upon by both parties.

Ijara wa-iktina

Ijara wa-iktina or 'lease purchase financing' refers to a contract where the bank purchases an asset for the purpose of renting the same to the customer against an agreed rental, together with the client's agreement to make payments which will eventually lead to the transfer of ownership from bank to customer.

Qard hassan

This is a benevolent loan that obliges a borrower to repay the lender the principal sum borrowed on maturity of the loan. The borrower, however, has the discretion to reward the lender for his loan by paying any sum over and above the amount of the principal.

Wadiah

Wadiah or 'trusteeship' refers to an agreement between the owner of assets (excluding immovable fixed assets) and another party, whereby the owner will

deposit and give consent to the custodian to make use of their assets (funds) as long as these assets remain in the custodian's hands.

Rahn

Rahn means 'pledge' or 'pawn'. It is a contract of pledging a security and becomes binding when possession of the pledge has taken place. In this principle the ownership of the security is not transferred to the pledgee. The transfer occurs only under certain conditions.

It is the consensus among Muslim scholars that the various principles adopted by Islamic banks belong to two categories, (i) strongly Islamic, and (ii) weakly Islamic. The principles can be considered 'strongly Islamic' if they conform to Islamic objectives both in form and in substance. 'Weakly Islamic' principles refer to practices which conform to Islamic norms in form but not in substance. The basis for judgement as to the strength or weakness of a given principle is the extent to which that mode contributes toward achievement of the objectives of Islamic economics (Islamic economics is a social science which studies the economic problems of people imbued with the values of Islam). Thus, only those principles which permit risk-return sharing between providers and users of funds can be considered strongly Islamic. Muslim scholars consider only two principles, i.e. *mudaraba* and *musharaka*, as strongly Islamic and the remaining principles are recommended only in cases where risk-return sharing cannot be implemented (Mirakhor, 1987).

3.6 Positive Laws and Regulations

There is no uniformity of law to be followed by Islamic banks around the world. In most Muslim countries, a special law is passed prior to any establishment of Islamic banks and this law normally will specify the rules and regulations for the institution

which wishes to engage in banking business based on Islamic principles. This law is either for the Islamic banking institutions in general or for a particular Islamic bank which is going to be established in that country.

In Malaysia, for example, the Islamic Banking Act 1983 was passed by Parliament prior to the establishment of the Bank Islam Malaysia Berhad in 1983 and this law applies to any Islamic banking institutions wishing to operate in Malaysia. This law consists of eight parts. Part I contains the short title, commencement, application and interpretation; part II contains provisions relating to the licensing of Islamic banks; part III deals with the financial requirements and duties of Islamic banks; part IV deals with ownership, control and management of Islamic banks; part V pertains to the restrictions on business; part VI relates to powers of supervision and control over Islamic banks; part VII provides for miscellaneous matters such as indemnity, priority of sight and saving account liabilities and penalties on directors and managers; and lastly part VIII contains provisions for consequential amendments that need to be made to other related Acts to enable Islamic banks to carry on their operations.

Similarly in Turkey, the decision to allow Islamic banks to operate in that country was contained in Decree 83/7506 of December 1983 and published in Official Gazette 18256 dated 19 December 1983. It contains 17 articles and deals with the method and procedures of the founding of the Special Finance Houses, their activities and liquidation, under the Protection of the Exchange Value of the Turkish Currency Law number 1567 and Decree number 70 regarding banks. More comprehensive rules and regulations for Islamic banks were formulated by the Undersecretariat of the Treasury and Foreign Trade and published in Official Gazette 18232 of 25 February 1984. There are 35 articles covering 'the founding structure, operation and liquidation of the Special Finance Houses'. The decree covers matters such as the minimum amount of capital required to set up a finance house and the types of accounts that the finance houses may offer to the public (Baldwin, 1990).

In Egypt, however, a special act was passed for a particular Islamic bank. In the case of the Faisal Islamic Bank of Egypt (FIBE), this institution was established by a Special Act (number 48) of 1977. This Act stipulates various privileges for the bank and gives it full autonomy beyond any influence from government bodies (with the exception of the supervisory role of the Central Bank). Again, when the Islamic International Bank for Investment and Development wanted to be incorporated in 1980, a special ministerial decree was issued in accordance with the Investment Law of Arab and Foreign Funds and Free Zones Law (number 43) of 1974 (El-Ashker, 1990).

In Jordan, the establishment of the Jordan Islamic Bank was within the ambit of a Temporary Special Law No. 13 of 1978 and this law was replaced by Law No. 62 of 1985 (Jordan Islamic Bank's annual report, various issues). In Kuwait, a special government decree which recognised the Islamic nature of banking was passed by the Kuwait government before the establishment of the Kuwait Finance House on 23 March 1977 (Wilson, 1990).

Although both Iran and Pakistan have changed their total banking system to the Islamic banking system, there are no similarities in banking law formulation in these two countries. In Iran, following the revolution in 1979, the banking system was nationalised and the 'Law for Usury-Free Banking' was passed in parliament in August 1983. This law is broadly divided into four chapters, namely 'Aims and Duties of the Banking System', 'The Mobilization of Monetary Resources', 'The Granting of Facilities', and lastly, 'The Central Bank of the Islamic Republic of Iran and the Monetary Policy.' (Herdayati, 1993). Although Iran has introduced this new law, it does not mean that all previous laws which regulate the banking system are no longer operative. The provisions or articles in the Money and Banking Law of 1972 which do not violate the principles set forth in the new law remain effective (Shojaeddini, 1993).

Unlike Iran, Pakistan does not have a comprehensive single law which deals with Islamic banks. The process of Islamisation of the whole banking system was done gradually and the rules and regulations on this matter are given on a continuing basis. The rules and regulations are usually in the form of a declaration made by the Minister of Finance or a circular issued by the State Bank of Pakistan (the Central Bank of Pakistan). For example, BCD Circular No. 13 of the State Bank of Pakistan prescribed the date of implementing the changing nature of financing facilities from interest-based to interest-free and a similar instruction was given to the deposit facilities. The permissible modes of financing together with the possible modes of financing for various transactions were also given in this Circular (Siddique, 1985).

Not all Islamic banks have gained a footing through such supportive state intervention. In Sudan, for instance, the Islamic banks were adversely affected by regulatory measures. At first, they were exempted from a number of existing banking rules, but these privileges were withdrawn after the regime which wanted to Islamise the country's banking system was overthrown in 1985 (Ahmed, 1990). In 1994, the Sudan government again decided to Islamise the banking system and this time the effort was much more earnest and much better organised (Ahmad, 1994). Similarly in the United Kingdom, regulatory issues have arisen as a result of the development of Islamic banking. Islamic banks are not regarded, however, as deposit-taking institutions by the Bank of England and they therefore fall in the peripheries of its regulation (Temple, 1992).

As mentioned earlier, although most of the Muslim countries have enacted special laws governing the operations of Islamic banks, this does not mean that Islamic banks are only subject to that particular law. As a normal business entity, any Islamic bank is expected to follow the laws and regulations relevant to other business entities or laws related to activities which Islamic banks intend to perform. Another interesting development is that the commercial transactions of Islamic banks in Malaysia come

within the jurisdiction of the civil court. Therefore, any legal proceedings between the Islamic bank and its customers are to be handled by the normal civil court and not a *Shariah* court.

3.6.1 Intervention by the Central Bank

Islamic banks, being part of the financial system, are also subject to the regulation and supervision of the Central Bank. In fact, the Central Bank has a function to play in the Islamic banking system just as it does in the conventional banking system. This function is also in line with the *Shariah* law that Islamic banks are accountable to those who are responsible for the financial affairs of the nation.

There are many similarities in terms of powers vested in the central banks of the Muslim countries in regulating and supervising the Islamic banks. In Turkey for example, besides the special decree passed by the Council of Ministers, the Central Bank of that country has also issued rules governing the Islamic banks. These rules appear in Official Gazette 18348 dated 21 March 1984. In all there are 18 articles that stipulate the requirements for the application and issue of licences to establish Islamic banks. The general outlines of some activities of Islamic banks are also given in this Gazette. An application to operate an Islamic bank in Turkey will be scrutinised by the Central Bank and the licence will be issued by the Council of Ministers based on recommendations made by the Central Bank. The Central Bank of Turkey is also responsible for determining the reserve and liquidity ratios, and for conducting an audit of all the accounts and operations of Islamic banks (Baldwin, 1990).

In Malaysia, the Islamic Banking Act 1983 prescribes the powers of the Central Bank over the Islamic banks. Any application to establish Islamic banks in Malaysia must be forwarded to the Central Bank and it will scrutinise the application and make a recommendation for approval or rejection. The existing licence of any Islamic bank

may also be revoked on the recommendation of the Central Bank. Islamic banks must first seek approval or report to the Central Bank regarding the following practices and proposals:

1. To open a new branch, agency or office in any part of Malaysia or outside Malaysia.
2. To establish a corresponding banking relationship with any bank outside Malaysia.
3. Proposed change in the control of the bank.
4. Whenever a loan or advance is made and secured in the aggregate by twenty per centum or more of the paid-up capital shares of any other Islamic bank or of any licensed bank under the Banking Act 1973 incorporated in Malaysia or of any finance company licensed under the Finance Companies Act 1969.
5. To grant advances, loan and credit facilities to its directors, officers and employees.
6. In case of the inability to meet its obligations or if the bank is about to suspend payment.
7. Proposed amendment or alteration in the memorandum and articles of association.

The Central Bank also has the power to regulate and conduct the following tasks:

1. The maintenance of paid-up capital and the reserve funds.
2. The establishment of minimum amounts of liquid assets to be held by the bank at all times.
3. The types and contents of reports to be submitted to the Central Bank.

4. The format of presentation and contents of the financial statements prepared by the Islamic banks.
5. The restriction in granting advances, loans and credit facilities.
6. The investigation and examination of books, accounts and transactions of the Islamic banks.

The Council of Islamic Ideology of Pakistan, in its report on the elimination of interest from the economy, mentioned that most of the monetary policy instruments available to the State Bank (the Central Bank for Pakistan) under the various banking laws of the country would also remain largely unaffected in an interest-free system. The regulatory instruments that would remain wholly or largely unaffected are: (a) minimum cash reserve requirement; (b) liquidity ration requirement; (c) overall ceilings on the lending and investment operations of banks; (d) mandatory targets for providing finance to priority sectors; (e) selective credit controls; (f) issue of directions to banks on various aspects of banking operations not covered by specific policy instruments; and (g) moral suasion (Ahmed, et al., 1983). Most of these instruments are also being used by other Muslim countries in regulating Islamic banks.

In Iran, however, further steps were taken by its Central Bank in regulating the banking system. According to Article No 20 of the Law for Usury-Free banking, the Central Bank of Iran is empowered to supervise money and banking affairs through the application of the following instruments (Shojaeddini, 1993):

1. Fixing a minimum and/or maximum share of profit for banks in their joint venture and *mudarabah* activities; these ratios may vary for different fields of activities.
2. Designation of various fields for investment and partnership within the framework of the approved economic policies, and the fixing of a

minimum expected rate of profit for various investment and partnership projects; the minimum expected rate of profit may vary with respect to different branches of activities.

3. Fixing minimum and maximum profit margins banks could charge for instalment and hire-purchase contracts.
4. Determining the types of services that banks could provide and the fixing of minimum and maximum commissions banks could charge for these services (provided that they do not exceed the actual expenses for the services rendered) and attorney-fees for managing the investment deposits.
5. Determination of the type and amount of minimum and maximum bonuses under Article 6, and the fixing of criteria for advertisements by banks in this respect.
6. Determination of the minimum and maximum ratios of equity participation, *mudarabah*, investment, hire-purchase, instalment transactions, buying and selling on credit, forward sales, *mozaraah*, *mosaqat*, *jo'alah*, and *qard hassan* for banks in each one of the various cases and fields; and also fixing the maximum amount of facilities that can be granted to any single customer.

3.6.2 Shariah Supervisory Committee

Another regulatory body that supervises Islamic banks is called the *Shariah* supervisory committee, sometimes known as the *Shariah* supervisory board. The main function of this committee is basically to ensure that the operations of the Islamic banks are not violating any *Shariah* principles. In other words, the committee has the responsibility to ensure that firstly, the banking facilities and services offered to customers are in keeping with *Shariah* laws; secondly, the investments or projects

in which the bank has its interests are permissible by *Shariah*; and finally that the bank itself is managed according to Islamic principles.

The setting up of this committee may vary from country to country. In Malaysia, for example, as stipulated in Section 5 of the Islamic Banking Act 1983, the Central Bank will not recommend the granting of a licence to the Islamic bank unless it is satisfied that there is, in the articles of association of the bank concerned, provision for the establishment of a *Shariah* advisory body. The function of this body is to advise the bank on the operations of its banking business in order to ensure that they do not involve any element that is not approved by the religion of Islam. In the case of the Faisal Islamic Bank of Egypt, the appointment of the *Shariah* Board is stated in its articles of establishment which specify that:

A Religious Supervisory Board shall be formed within the Bank to observe conformance of its dealing and actions with the principles and rulings of Islamic *Shariah*. The Bank Statues shall determine the process of forming this Board, the way it shall conduct business as well as its other functions.

The appointment of the members in the *Shariah* Boards also varies from one bank to another. Article 40 of the Statutes of the Faisal Islamic Bank of Egypt, for example, states:

The Supervisory Board shall be composed of no more than five members selected from amongst Islamic scholars and jurists of Comparative Law believing in the idea of the Islamic Bank. The general meeting shall appoint them every three years and shall fix their remuneration upon the proposal of the Board of Directors.

Contrary to the practice adopted by the Faisal Islamic Bank of Egypt, the appointment and dismissal of the *Shariah* Board for the Faysal Islamic Bank of Bahrain is made by the Board of Directors. Article 40 of this bank's Memorandum and Articles of Association says:

The Board of Directors shall nominate, constitute and maintain a Religious Supervisory Board composed of at least three persons who are acknowledged experts in Islamic principles, laws and traditions. Members of the Religious Supervisory Board shall be designated by the Board of Directors and may be removed by the same at any time.

Similar to the Faysal Islamic Bank of Bahrain, the appointment of the *Shariah* Board for the Jordan Islamic Bank is made by its Board of Directors. In the case of dismissal, however, unlike the Faysal Islamic Bank of Bahrain where the *Shariah* Board can easily be removed by the Board of Directors, certain procedures have to be followed by the Jordan Islamic Bank. Section 27 (b) of Law No. 13 of 1978 for the Jordan Islamic Bank states:

The consultant so appointed to this post may not be dismissed except on the basis of a Board resolution adopted by a two thirds majority of the members at least, and giving the grounds for such dismissal.

In countries such as Iran and Pakistan, the establishment of this committee is unnecessary. This is because the government has a central body that gives a ruling or '*fatwa*' on banking operations. The committee's report on whether the operations of the bank are being conducted in accordance with the *Shariah* principles or otherwise is normally presented in the bank's annual report. In some cases, the committee is entrusted not only with religious matters but also with other matters. For example, as stated in Article 2 of the Higher Board's Statute, the *Shariah* Supervisory Board of the

International Association of Islamic Banks is entrusted with the following duties (Presley, 1988):

1. To study the '*fatwa*' previously issued by the religious supervisory boards of member banks, in an attempt to make decisions identical.
2. To study the previously issued '*fatwa*' to see how far they conform with the rulings of Islamic *Shariah*.
3. To supervise the activities of the Islamic banks and financial institutions and members of the Association to ensure their conformity with the rulings of the Islamic *Shariah*. In addition it has to draw the attention of the concerned parties to any potential violation of these activities. In discharging its duties, the Board has the right to go through the laws and by-laws of member banks and financial institutions and to draw their attention to whatever violation might have been made in this respect. In so doing, utmost confidentiality must be observed.
4. To issue legal religious opinions on banking and financial questions in response to requests by member Islamic banks and financial institutions, or their religious supervisory boards or the secretariat general of the Association.
5. To study matters related to financial and banking operations in response to requests for advice from Islamic financial institutions.
6. Decisions and '*fatwa*' of the Board are obligatory and binding on member banks and financial institutions in cases where these are already approved by all members. However, any member bank or financial institution is entitled to ask for reconsideration of any decision. A detailed note must then be submitted in cases of disagreement as any bank is entitled to follow any course of action in the disagreement unless it is otherwise enforced by the Board.
7. To clarify legal religious rulings on new economic questions.

Chapter 4

OPERATIONAL ASPECTS AND PRACTICES OF ISLAMIC BANKS

4.1 Introduction

As mentioned in Chapter 2, the existence of Islamic banks is intended to promote, foster and develop banking services and products based on Islamic principles. The main principles of Islamic banking comprise prohibition of interest in all forms of transactions, business undertaking and trade activities. All Islamic banks are founded on the same Islamic business principles and governed by the same laws, i.e. *Shariah* laws (as highlighted in Chapter 3).

Theoretically there should be no differences among Islamic banks in terms of operations and practices. In reality however, slight differences in practices do occur among the Islamic banks in various Muslim countries. This is largely due to the variation in the interpretation of the principles governing banking practices. Furthermore, every Muslim country has its own religious authority which is responsible for monitoring and supervising the activities of Islamic banks in that country. The religious authority of a particular country is independent of the religious authorities of other countries and *fatwa* (directives of a particular law issued by either Islamic religious bodies or by a learned man) of a particular country are not applied to communities beyond its jurisdiction.

The objective of this chapter is to review the operational aspects and practices of selected Islamic banks in various Muslim countries. This review covers the services and products available to customers, the usage of *Shariah* principles for various banking products and services, sources and uses of funds, and accounting policies and procedures adopted by these Islamic banks. These operational aspects and practices are mostly within the control of management and have a direct relationship with profitability (details discussed in Chapter 6). The review will also serve as a foundation and a guideline in the process of developing and selecting profitability determinants which will be used for this study. The selection of banks for comparative purposes is based on the availability of information on their banking activities. Most of the information used in this review is taken from annual reports, correspondence and existing literature. While the operations of banks in the sample were reviewed, the operations of banks in Pakistan and Iran were also highlighted for comparison purposes. The Muslim Commercial Bank of Pakistan (MCB) and Bank Meli of Iran (BMI) represent the operations of Islamic banks in these two countries.

4.2 Usage of *Shariah* Principles

A list of *Shariah* principles adopted by various Islamic banks in selected countries is given in Table 4.1. Among the salient features in the application and elaboration of the *Shariah* principles by Islamic banks, the following points are especially noteworthy:

- i) the use of terminology;
- ii) category of principles;
- iii) number of principles;
- iv) country-specific principles.

4.2.1 The Use of Terminology

Malaysia is the only country where Arabic words are used in describing all *Shariah* principles governing Islamic banking operations. Other countries, however, retain Arabic words for certain principles only and use vernacular words for others. Some of the Arabic words which are commonly used by almost all Islamic banks are the principles of *mudaraba*, *musharaka*, *murabaha*, *ijara* and *qard hassan*. The slight differences in spelling are due to the variations in pronunciation of the words in different countries.

With respect to terminology, two conditions have been observed: first, where the same practices are conducted but different terms applied; second, where the same term is applied but different methods are practised. An example of the first condition is the case of deferred payment. The principle of *bai-mua'zzal* is used by IBBL of Bangladesh, but in Malaysia this principle is known as *bai bithaman ajil*. Similarly, the principle of instalment sales which is used by banks in Iran deals with deferred payment financing. The principle of *bai salam* of IBBL is a principle in which the bank will make an advance purchase and the customer will deliver the goods at a later date. This principle is similar to the principle of forward delivery which is used by banks in Iran. The principle of *bai al-dayn* used in Malaysia is for transactions involving sale and purchase of trade documents such as bills of exchange and banker's acceptances. This principle is similar to the principle of debt purchasing practised in Iran.

An example of the second condition, that is, where the same term is applied but different methods are practised, is the case of *murabaha*. In Malaysia and Bangladesh, this principle covers mark-up transactions on a cash basis, whereas in the Middle East countries the principle of *murabaha* covers both cash and deferred

transactions. In the case of deferred transactions, some banks refer to this principle as *bai-murabaha*.

4.2.2 Category of Principles

Not all banks have adopted all categories of *Shariah* principles which govern the banking operations. As stated in Chapter 3, there are four categories of *Shariah* principles for banking, namely:

- i) profit & loss sharing principles;
- ii) fees or charges based principles;
- iii) free services principles; and
- iv) ancillary principles.

Except for IBBL of Bangladesh, JIB of Jordan, FFI of Turkey, and the Islamic banking system in Malaysia, which have adopted principles in all four categories, Islamic banks in other countries employ only three of the above-mentioned four principles (see Table 4.1). Although these banks do not mention other ancillary principles, such as *wadiah* (trust) and *rahn* (mortgage), in practice they too are involved in the activities which fall within the ambit of *wadiah* and *rahn*. For example, IBB of Bahrain, BMI of Iran, KFH of Kuwait, MCB of Pakistan, FIBS of Sudan, BEST of Tunisia, and DIB of the United Arab Emirates provide mortgage-based finance. Similarly, current account facilities at MCB of Pakistan, and KFH of Kuwait, are based on *wadiah*.

4.2.3 Number of Principles

Within the four categories of principles there can be as many as 14 different principles employed by Islamic banks in their operations. Both IBB of Bahrain and DIB of the United Arab Emirates have the least number of principles, i.e. five. The State Bank of Pakistan, which is the Central Bank of Pakistan, has provided 12 principles to be used by all banks in Pakistan. Likewise in Iran, the Law for Usury-Free Banking 1983 has also listed 12 principles.

Within the category of profit-loss sharing, except for Iran and Pakistan which have more than two principles, and IBB of Bahrain which has only one principle, i.e. *musharaka*, other Islamic banks have two principles, i.e. *musharaka* and *mudaraba*. Although it seems that Iran and Pakistan have more principles within the profit and loss category, these additional principles actually operate along the lines of both *musharaka* and *mudaraba*.

In the category of fee-based principles, DIB of the United Arab Emirates has two principles followed by JIB of Jordan with three principles. Malaysia, which has only one fully-fledged Islamic bank, i.e. BIMB, has the highest number of principles, with nine, followed by Islamic banks in Pakistan which have seven principles. Principles in this category are used universally by Islamic banks irrespective of countries. Principles within this category are further divided into three categories, namely, (i) fees based on mark-up, (ii) fees based on commission, and (iii) fees based on services. Products or services whose charges are based on mark-up are usually governed by the principle of *mudaraba*, *ijara* (leasing), *ijara wa-iktina* or lease-purchased (or *istisna* for Kuwait and *taajir* for Tunisia), hire-purchase, and *bai mua'zzal*. The marked-up amounts are based on the nature of the transactions and the length of the credit given to the customer. Commission is usually received by Islamic banks for transactions based on the volume or amount.

However, service charges are imposed on customers upon utilisation of bank services and the rate is fixed in line with the nature of services.

As for the free services category, all banks have adopted the principle known as *qard hassan*. In addition, three banks (IBBL, JIB, and FFI) and Islamic banking in Malaysia have listed other principles which fall within the 'ancillary' category.

4.2.4 Country-specific Principles

Besides common principles (as explained in Chapter 3) some countries have specific *Shariah* principles for their Islamic banks. Although these principles are country-specific, this does not necessarily mean that other countries are not familiar with those principles. While the other countries may apply these practices, they do so by incorporating them into general banking rather than within specific *Shariah* principles. As stated at the beginning of this chapter, each Muslim country has its own religious body and it is independent. Therefore, it is the prerogative of the religious body within each country to establish its own principles and a particular principle adopted by a specific country is not necessarily regarded as a distinct principle by other countries.

In the case of Iran, for example, there are five additional principles within the profit-loss sharing category, namely, civil partnership, legal partnership, direct investment, *mozaarah* and *mosaqat*. While civil partnership, legal partnership and direct investment deal with the legal aspects of the formation of new ventures, both *mozaarah* and *mosaqat* are methods of agricultural financing. The principle of civil partnership operates on the contribution of cash or non-cash capital by several persons or legal entities to a common pool on a joint-ownership basis, with the intention of making profit. This partnership will be terminated when the objectives of this partnership are accomplished. While civil partnership is

common in the Western world, banks do not directly participate in them. Legal partnerships are created by establishment of new joint-stock companies. In the case of direct investment, Iranian banks will make the investment or provide additional capital for productive projects. *Mozaraah* is a contract wherein one of the parties called *mozare* (bank) gives a specified plot of land for a specified period of time to another party called *amel* (contractor) for the purpose of farming, and they will divide the harvest between them according to an earlier agreed ratio. *Mosaqat* is a contract between the owner (bank) of trees and the like with another party in return for a specified common share of the produce. Iran also has an additional principle called *jo'alah*. *Jo'alah* is the undertaking of one party, *ja'el*, or an employer (either bank or customer) to pay a specified amount of money or wage to another party in return for rendering a specified service in accordance with the terms of the contract.

In the case of Pakistan, principles such as equity participation, participation term certificates, *modaraba* certificates and rent sharing also operate on a profit-loss sharing concept. Equity participation involves the purchase of shares of companies by the bank. The bank will be treated as an ordinary shareholder of the company and will receive returns in the form of dividends. Participation term certificates are transferable financial instruments issued by a company for a specified period and are secured by a legal mortgage on the fixed assets of the company. A *modaraba* certificate is issued by companies which are registered under the *Modaraba* (Floating and Control) Ordinance of 1990. The returns on participation term certificates and *modaraba* certificates are determined by the profitability of the issuing company. In the case of rent sharing, the bank provides finance for the building of houses, shopping complexes, flats, apartments, etc., and receives a share of the rental income of the property. In other countries, these activities are incorporated largely within the principles of *musharaka* and *mudaraba*.

Although Pakistani banks and Islamic banking in Malaysia seem to have many *Shariah* principles for their fixed charges category, these principles can be grouped together within the principles of service charges. In Pakistan, for instance, development charges and service charges are terms used in imposing charges on customers. Similarly in Malaysia, the principles of *al-wakalah*, *al-kafalah*, *al-hiwalah*, and *al-ujr* are terms representing the nature of services rendered to customers and how these charges will be imposed on customers.

The concept of *al-wakalah* (agency) which is used by BIMB of Malaysia refers to a situation where a person nominates another person to act on his behalf. *Al-kafalah* (guarantee) refers to the guarantee provided by a person to the owner of goods, who has placed or deposited his goods with a third party, whereby any subsequent claim by the owner with regard to his goods must be met by the guarantor, and not by the third party. *Al-hiwalah* (remittance) refers to a transfer of funds/debt from the depositor's/debtor's account to the receiver's/creditor's account, and the concept of *al-ujr* (fee) refers to commissions or fees charged for services. These principles are unique to BIMB.

Table 4.1
List of Shariah Principles Practised in Selected Islamic Countries

Category	Bahrain	Bangladesh	Iran	Jordan	Kuwait	Malaysia	Pakistan	Sudan	Tunisia	Turkey	UAE
(A)	Musharakah	Al-mudharabah Musharakah	Civil partnership Legal investment Modarabah Mozarah Mosaqat	Mudarabah Musharakah	Mudarabah Musharakah	Al-mudharabah Al-musyarakah	Mushrika Equity participation and purchase of share Participation term certificate (PTC) Modarabah Rent sharing	Mudarabah Musharakah	Mudharabah Musharka	Mudarabah Musharakah	Mudarabah Musharakah
(B)	Morabaha Commission Service charges	Bai-mua'zzal Bai-salam Hire-purchase Ijara Murabaha Commission Service charges	Forward delivery transaction Instalment sales Jo'alah Debt trading Hire-purchase	Murabaha Commission Service charges	Murabaha Commission Service charges Istisna Leasing	Al-murabahah Bai bithaman ajil Bai al-dayn Al-ijarah Al-ijarah thumma al-Peri Al-wakalah Al-kafalah Al-hiwalah Al-ijr	Mark-up Purchase of trade bills Buy-back arrangement Leasing Hire-purchase Development charges Loan with service charges	Murabaha Ijara Commission Service charges	Murabaha Taqir Commission Instalment sales	Morabaha Ijara Ijara wa-ikhtina Commission Service charges	Murabahat Service charges
(C)	Qard hassan	Qard-e-hasana	Qard al-hasanah	Al-qird al-hassan	Qard hassan	Al qardhal hasan	Qarz-e-hasna	Qard hassan	Interest free	Interest free	Qard hassan
(D)		Wadi'ah		Wadi'ah		Ar-rah Al-wadi'ah yad dhamanah				Trust	

Notes:

- (A) Profit and loss sharing principles
- (B) Fees or charges based principles
- (C) Free services principles
- (D) Ancillary principles

Sources: Bahrain: IBB's 1994 annual report; Bangladesh: IBBL's CAD letter dated 21 March 1994; Iran: The Law for Usury-Free Banking 1983; Jordan: JIB's 1993 annual report; Kuwait: KFH's 1993 annual report; Malaysia: Money and Banking, Bank Negara Malaysia 1994; Pakistan: State Bank of Pakistan's BCD Circular No. 13, 20th June 1984; Sudan: Ahmed, 1990; Tunisia: B.E.S.T Bank's 1992 annual report; Turkey: FFI's 1993 annual report; United Arab Emirates: DIB's 1992 annual report.

4.3 Services Available

As explained in Chapter 2, the central objective of Islamic banks is to provide banking facilities and services in accordance with Islamic principles, rules and practices. This means Islamic banks provide saving facilities to depositors and extend loans to deficit units. Normal deposit facilities such as savings accounts, current (checking) accounts, fixed or investment deposits are available to customers. Islamic banks are also involved in facilitating international trade for their customers. Services such as letters of credit, bills for collection, letters of guarantee, buying and selling of foreign currencies, and remittance services are also available at Islamic banks.

Advisory services are provided by Islamic banks in many countries. These services include project planning, property management, preparation of feasibility studies, project evaluation, trustee services and training and education in Islamic finance and economics. Unlike conventional banks, Islamic banks are also actively involved in social activities. The services that are considered as social service include benevolent loans, collection and distribution of *zakat* (alms or wealth tax) funds, donations and other activities that will enhance Islamic values and ways of life.

4.3.1 Deposit Facilities

The types and composition of deposit facilities available at Islamic banks and in selected Islamic countries are listed in Table 4.2. Some of the similarities and differences in terms of deposit facilities are highlighted below:

1. Except for FFI of Turkey which offers only two types of deposits facilities, i.e. special current accounts and PLS "*modaraba*" accounts, Islamic banks in other countries provide three types of deposit facilities to their customers, i.e. current accounts, savings accounts and investment account facilities.

2. The three types of deposit facilities available at Islamic banks, i.e. current, savings and investment accounts, can fall within various groupings of Islamic principles such as profit and loss sharing, free services and ancillary principles. The most common principles used by Islamic banks are *mudaraba* from the category of profit and loss sharing, *qard hassan* from the category of free services, and *wadiah* from the category of ancillary principles.
3. There are, however, some differences in the treatment of the savings account facility among Islamic banks. Islamic banks in Iran, BIMB of Malaysia, El Gharb of Sudan, and DIB of the United Arab Emirates, for example, regard savings accounts as a facility by itself. In contrast, IBB of Bahrain, IBBL of Bangladesh, JIB of Jordan, KFH of Kuwait, and BEST of Tunisia consider savings accounts as one of the facilities within the category of investment accounts.
4. Investment account facilities have been divided into three categories, namely, (i) deposits based on time (e.g., for three months, six months, nine months, etc.), (ii) deposits based on notice (i.e. notice must be given by customers prior to any withdrawal), and (iii) deposits for specified projects or purposes. Investment account facilities based on time are available at all Islamic banks in all countries. Investment deposit facilities based on notice, however, are only available at IBBL of Bangladesh and JIB of Jordan. Customers of IBBL must give seven days notice prior to any withdrawal and 90 days notice at JIB. Specific investment facilities are available in most countries except Iran, Kuwait, Pakistan and Turkey. In Tunisia, the investment account is divided into two categories, namely, (i) participating deposit account, and (ii) committed participating deposit. A participating deposit account comprises *tawfir* or a savings account and time deposit. The operations of these two accounts are similar to those savings and investment accounts of other Islamic banks. In the case of the committed participating deposit account, its operations are very similar to special or specific investment deposit facilities provided by other banks.

5. In practice, Islamic banks provide a guarantee to return the full amount of deposits placed by customers in accounts even though the facilities operate on *qard hassan* or *wadiah*. But no guarantee is given for deposits which operate under the principle of *mudaraba*. In *Shariah*, any property placed under the principle of *wadiah* cannot be used by the trustee without permission of the owner. Therefore, in the case of IBBL of Bangladesh, JIB of Jordan, KFH of Kuwait, BIMB of Malaysia, and DIB of United Arab Emirates, they have to obtain the customer's approval to allow them to utilise the funds at the bank's risk and for the bank's benefit. This means any return from the utilisation of the said funds belongs to the bank and similarly in the case of loss the burden will be on the bank alone. Both Malaysia and Iran provide some kind of returns to their savings account customers. These rewards however are solely based on the discretion of the banks and the customers will have no prior knowledge of the reward. Non-fixed prizes of bonuses in cash or in kind, such as air tickets to holy shrines, carpets, gold coin or even cars; an exemption from, or reduction in, payment of a commission for banking services; and priority in the use of banking facilities are some of the examples of rewards given by Islamic banks in Iran (Aryan, 1990). In Malaysia, the reward for savings account holders is usually in the form of rates of profit announced by the bank on a monthly basis.

In most cases, the operational aspects and practices of these deposits facilities are similar to practices of conventional bank deposits facilities. These similarities include the procedures and requirements such as minimum deposits for opening the account, identification, stop payment on cheques, closing the account, management of unclaimed monies, and so on.

Some of the salient features relating to the composition of deposits facilities as indicated in Table 4.2 are given below:

1. Accounts which operate on the *mudaraba* principle are the best-received deposit facilities among Islamic bank customers. In the case of IBB of Bahrain, for

example, at the end of 1994 the total funds provided by these facilities were 90% of the total deposits. Turkey had a similar percentage to that of IBB of Bahrain. El Gharb of Sudan had the lowest percentage for this kind of account, that is, 10% of the total deposits.

2. Savings account facilities operating on a *mudaraba* principle are more attractive to depositors as compared to the investment account facility (all investment accounts operate on the *mudaraba* principle). At MCB of Pakistan, for example, the percentage for savings accounts was 45% and 24% for investment accounts; for IBBL Bangladesh, it was 45% against 35%; 58% and 26% for KFH of Kuwait, and 57% and 34% for IBB of Bahrain. JIB of Jordan is the only bank which differs from this trend and the percentage for savings accounts was 8% and 71% for investment accounts. These percentages are based on total deposits.
3. The percentage of savings accounts (relative to total deposits) operating on principles other than *mudaraba* is smaller, not only compared to the percentage of current accounts, but also to savings accounts which operate on *mudaraba*. For example, the percentage of savings accounts of BIMB is 15% and 17% for current accounts. BMI of Iran has the smallest percentage of savings accounts, i.e. 5% of the total deposits.
4. Current accounts are also major providers of funds to the Islamic banks, especially for Islamic banks in Sudan. At the El Gharb of Sudan for example, as at the end of 1993 the current accounts constituted 57% of total deposits. BMI of Iran also has a high percentage of current accounts as compared to other deposit facilities, i.e. 34%. For other banks, about 20% of deposits are placed in current accounts, although FFI of Turkey and BIB of Bahrain hold funds deposited in current accounts which constitute 10% or less of total deposits..
5. Both current and investment accounts facilities using foreign currencies have received a tremendous response from customers in Turkey. At the end of 1993, these accounts constituted 85% of the total deposits placed by FFI customers.

Other banks do not indicate the contribution of foreign currency accounts in their annual reports.

6. BIMB of Malaysia is the only bank where the figure for the 'other deposits' facility was higher than current and savings accounts figures. The customers who deposited their money into this facility are mainly members of government or government agencies. Usually the terms for this deposit are subject to the outcome of negotiations between the bank and the depositor. Similarly for El Gharb of Sudan, the figure for the 'other deposits' facility was higher than savings and investment accounts figures. In Sudan, however, the bulk of this deposit is mainly from marginal deposits required by the Bank prior to the issuance of letters of credit.

Table 4.2
The Types and Composition of Deposit Facilities Available at Islamic Banks in Selected Countries

Bahrain	%	B'desh	%	Iran	%	Jordan	%	Kuwait	%	M'sia	%	P'tan	%	Sudan	%	Tunisia	%	Turkey	%	UAE	%
CA	10	CA	19	QH CA	34	TrA	20	CA	17	CA	14	CA&Con	20	CA	57	CA	11	CA:		CA	21
IA:		&ConA				JIA:		IA:		SA		PLS:		SA		SA		Turkish		SA	
SA	33	PLS:	45	QH SA	5	SA	8	SA	15	SA	58	SA	45	SA	2	SA	13	Foreign	4	IA	18
TD	57	TD	32	ID	52	F & NA	71	LP	50	IA	*	TD	24	ID	10	ID:		PLS:	6	IBD	59
		SND	4	IBD	9	IBD	1	UP	*	IBD	26	IBD	11	OD	31	UD	49	Turkish	11	OA	1
						IBD		IBD	18	OD	2	OD				CD	27	Foreign	79		
Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100
% TL	92	% TL	80	% TL	92	% TL	81	% TL	87	% TL	85	% TL	98	% TL	59	% TL	74	% TL	89	% TL	83

Notes:

1. QH: Qard hassan; CA: Current accounts; SA: Savings account; ID: Investment deposits; IBD: Inter-bank deposits; OD: Other deposits; ConA: Contingency accounts; TD: Term deposits; SND: Short notice deposits; IA: Investment accounts; LP: Limited period; UP: Unlimited period; TrA: Trust accounts; F&NA: Fixed and notice accounts; UD: Uncommitted deposits; CD: Committed deposits; TL: Total liabilities.
2. * Less than 0.5 %.
3. Contingency accounts which are available at MCB of Pakistan and IBBL of Bangladesh comprise marginal deposits placed by customers for using facilities such as letters of credit and bank guarantees.

Source:

Bahrain: IBB's 1994 annual report; Bangladesh: IBBL's 1993 annual report; Iran: BMI's 1992 annual report; Jordan: JIB's 1993 annual report; Kuwait: KFH's 1993 annual report; Malaysia: BIMB's 1994 annual report; Pakistan: MCB's 1993 annual report; Sudan: El Gharb's 1993 annual report; Tunisia: BEST's 1992 annual report; Turkey: FFI's 1993 annual report; United Arab Emirates: DIB's 1992 annual report.

4.3.2 Financing Facilities

Like conventional banks, Islamic banks are also actively involved in financing the needs of their customers. This means providing short, medium- and long-term funding facilities. Since Islamic banks are prohibited from making loans with interest to their customers, all financing operations are either based on profit-loss sharing or based on fixed charges. The principles of *mudaraba* and *musharaka*, based on profit-loss sharing concepts, are widely used by all Islamic banks in financing working capital loans. Principles such as *murabaha* and *bai-mua'zzal* tend to be used by banks to finance the purchase of fixed assets by customers. Principles of *murabaha* and *bai mua'zzal* are also commonly used by Islamic banks for customers who want to purchase raw materials and merchandise. For buying machinery and heavy equipment, the principles of *ijara* (hire purchase/lease) and *ijara wa-iktina* (lease purchased) are employed.

The financing activities of Islamic banks based on the principles of *Shariah* are shown in Table 4.3. Data for BMI of Iran, KFH of Kuwait, MCB of Pakistan, and El Gharb of Sudan are not available (letters and reminders were sent to all these banks but unfortunately no reply was received). Some of the general observations from Table 4.3 are:

1. The five modes of financing which are commonly used by Islamic banks worldwide are *musharaka*, *mudaraba*, *murabaha*, *ijara* and *qard hassan*. However, IBB of Bahrain uses only three modes of financing, i.e. *musharaka*, *murabaha*, and *qard hassan*. Similarly, DIB of United Arab Emirates also uses three modes, i.e. *musharaka*, *mudaraba* and *murabaha*.
2. There are some similarities among the Islamic banks in adopting Islamic principles in their financing activities. In the case of *musharaka*, for example, all

Islamic banks use two types of *musharaka*, (i) permanent *musharaka*, and (ii) diminishing *musharaka*. There is no time limit for permanent *musharaka* transactions and the bank will receive an annual share of profit on a pro-rata basis. This financing technique is also referred to as continued *musharaka*. Diminishing *musharaka* is a special form of *musharaka* which results in the discharging of the ownership of the asset or the project by the bank. This diminishing partnership has been successfully applied by the Jordan Islamic Bank, mainly to finance real estate projects and the construction of commercial buildings and housing projects.

3. Although the principles of *musharaka* and *mudaraba* are recommended by Islamic scholars, no Islamic bank used in this study is channelling more than 10% of its total financing portfolio along these modes of financing (see Table 4.3 for breakdown). Similarly with the principle of *qard hassan*. Except for IBBL of Bangladesh where the percentage of funds used for this mode of financing is 4%, the percentage for other banks is less than 1%.
4. There are some variations among Islamic banks in the use of *qard hassan* loans. Jordanian Islamic Bank Law allows the JIB to give *qard hassan* loans for productive purposes in various fields to enable the beneficiaries to start independent lives or to raise their incomes and standard of living. In the case of IBB, the *qard hassan* loan is used as assistance for persons to get married, for house repairs, medical treatment and for education. At the DIB, this loan is extended for productive purposes and available to shareholders or depositors. The amount, however, is relatively small and is provided on a short-term basis. In Malaysia, the *qard hassan* loan is extended by BIMB through other social organisations such as Amanah Ikhtiar Malaysia or AIM (AIM is a social organisation established by the Foundation of Islamic Economics of Malaysia with the objective of increasing the income of poor Muslims).
5. The principle of *murabaha* is the most widely used principle among Islamic banks. IBB of Bahrain, for instance, channelled 96% of its financing activities in the form of *murabaha*. Other banks with high percentages of *murabaha* are 85% for DIB of United Arab Emirates, 61% for FFI of Turkey, and 51% for IBBL of

Bangladesh. However, the percentage of *murabaha* for BIMB of Malaysia was less than 20%. This method is widely used by Islamic banks to satisfy different financing requirements of various sectors of economy such as industry, agriculture, domestic trade, construction and real estate, transportation, and international trade. There are not many variations in the usage of this principle among the Islamic banks. Basically it involves the purchase of raw materials, equipment, machinery, land and building from a third party in cash by the bank and then selling these to a customer on a marked-up price agreeable to both parties, i.e. the bank and the customer. The selling of goods to the customer can be on a cash or credit basis.

6. BIMB of Malaysia has the highest percentage of *bai bithaman ajil* principle financing, i.e. 68% of the total financing. Although there is no *bai bithaman ajil* principle for banks such as IBB of Bahrain, JIB of Jordan, FFI of Turkey, and DIB of United Arab Emirates, these banks incorporate a deferred payment facility within the principle of *murabaha*.
7. JIB of Jordan and FFI of Turkey have a high percentage of financing in the category of 'others', i.e. 42% for JIB and 21% for FFI. While no explanation is given by the JIB, the 'others' category for FFI comprises short-term investments abroad and advances made to vendors.

Islamic banks tend to finance all sectors within the economy. The funds, however, are not equally distributed among these sectors. The sectoral breakdown of loans is shown in Table 4.4. Lack of standardisation among Islamic banks in classifying the distribution of financing creates difficulties for comparative analysis. However, some of the general conclusions drawn from the data are as follows:

1. Sectoral financing of Islamic banks varies and is in line with the economic environment of the respective country. IBBL of Bangladesh, BMI of Iran, and FIBB of Bahrain concentrate on commercial and manufacturing sectors and the percentages were 93%, 64% and 61% respectively. Both BIMB of Malaysia and JIB of Jordan tend to concentrate on the miscellaneous sector (e.g., housing, real estate, manufacturing and services) and the percentage was 45% for BIMB and 50% for JIB. There is no sectoral concentration for FFI of Turkey.
2. Faysal Islamic Bank of Bahrain is the only bank involved in financing other banks and financial institutions. At the end of 1993, the funds allocated for this sector were 17%.
3. Except for FFI of Turkey, which is heavily involved in financing the agricultural sector, other Islamic banks are not really involved in this sector. At the end of 1993, 21% of total loans of FFI went to this sector, whereas IBBL of Bangladesh, BIMB of Malaysia and Jordan had allocated only 1%, 4% and 1% respectively. At the end of 1992, the percentage of total loans to this sector was 7% for BMI of Iran.

Table 4.4
The Distribution of Financing by Sector of Islamic Banks in Selected Countries

Bahrain	Bangladesh	Iran	Jordan	Malaysia	Turkey	%
Trading	6	Commerce & services	General trade	Wholesale & retail trade	Metals	21
Manufacturing	58	Industry & mining	Industry & mining	Manufacturing	Petro-chem	6
Real Estate	16	Construction & housing	Constructions	Construction	Textile	13
Agricultural	2	* Agricultural	Agricultural	Real estate	Constructions	5
Services	1	Others	Transport	Transport & storage	Machinery	10
Financial Insts.	17		Miscellaneous	Business services	Agricultural	21
				Others	Paper-pulp	3
					Food	11
					Chemicals	8
					Others	2
Total	100	100	Total	Total	Total	100

Notes:

1. Sectoral breakdown of loans is not available for IBB of Bahrain, KFH of Kuwait, MCB of Pakistan, El Gharb of Sudan, BEST of Tunisia and DIB of United Arab Emirates.
2. Figures taken from the Faisal Islamic Bank of Bahrain's 1993 annual report are used to represent Bahrain.

Sources:

Bahrain: FIBB's 1993 annual report; Bangladesh: IBBL's 1993 annual report; Iran: BMI's 1992 annual report; Jordan: JIB's 1993 annual report; Malaysia: BIMB's 1994 annual report; Turkey: FFI's 1993 annual report.

4.3.3 Other Facilities

Other facilities available at Islamic banks comprise letters of credit, letters of guarantee, collection of bills, sale and purchase of foreign currencies, and remittance services. In most cases, facilities such as letters of guarantee, sale and purchase of foreign currencies and remittance services are provided to customers on a commission and service fee basis. There are, however, slight variations in principle adopted by Islamic banks for letter of credit facilities. JIB of Jordan, FFI of Turkey, DIB of United Arab Emirates, FIBB of Bahrain and Islamic banks in Pakistan use *wakalah* and *murabaha* principles in providing this facility. In the case of *wakalah*, the customer must pay in advance the full value prior to the issuance of the letter of credit (i.e., fully-covered L/C). The bank will receive commission or service fees on the service rendered to the customer. Under the principle of *murabaha*, the bank will import or purchase goods and resell to customers on a mark-up price agreeable to both parties. The title to the goods will be transferred to customers on the arrival of the import documents. If the customer does not have a deferred payment facility, he or she must settle in full with the bank for the resale price and other charges prior to receiving the import documents.

At BIMB of Malaysia, principle of *musharaka* is used in addition to *wakalah* and *murabaha*. In this case, the Bank requires the customer to deposit a certain percentage of money (based on the agreement made with the Bank) prior to the importation of goods. The Bank will then issue a L/C and make payment using both the customer's and its own funds. The customer is responsible for selling the goods and returns the Bank's funds plus the Bank's share of the profit. IBBL of Bangladesh uses a similar approach as practised by BIMB of Malaysia for the letter of credit facilities.

The involvement of Islamic banks in providing these facilities is shown in Table 4.5. Some of the salient features of Islamic banks in offering these facilities are as follows.

1. The types of additional facilities provided by Islamic banks vary from one bank to another. While letters of credit and letters of guarantee are available at all banks, facilities such as foreign exchange and bills for collection are available only in selected banks, such as BMI of Iran, BIMB of Malaysia, MCB of Pakistan, IBBL of Bangladesh and KFH of Kuwait. JIB of Jordan, IBB of Bahrain, FFI of Turkey and DIB of the United Arab Emirates do not provide foreign exchange contracts and bills for collection services. In the case of El Gharb of Sudan, it does provide bills for collection facilities but not foreign exchange services.
2. The degree of involvement in offering additional facilities also varies from one bank to another. FFI of Turkey, for example, has total contingent liabilities almost equivalent to total assets. Similarly, for the El Gharb of Sudan total exposure in contingent liabilities is 89% of total assets. In contrast to FFI and El Gharb, IBB of Bahrain has the lowest exposure in terms of contingent liabilities. At the end of 1994, total contingent liabilities were only 3% of total assets. BEST of Tunisia is another bank which has a lower exposure in contingent liabilities at the end of 1992, i.e. 5% of total assets. While the percentage for BIMB of Malaysia, MCB of Pakistan and IBBL of Bangladesh was between 35% to 45%, the proportion for BMI of Iran, KFH of Kuwait, JIB of Jordan and DIB of the United Arab Emirates was below 15% of total assets.
3. There are also some differences in terms of emphasis of facilities extended by Islamic banks to their customers. BMI of Iran, MCB of Pakistan, IBBL of Bangladesh and JIB of Jordan seem to concentrate on letter of credit facilities, whereas BIMB of Malaysia, KFH of Kuwait and DIB of the United Arab Emirates tend to concentrate on providing letters of guarantee.

Table 4.5
The Contingent Liabilities of Islamic Banks of Selected Countries

Bahrain	%	B'desh	%	Iran	%	Jordan	%	Kuwait	%	M'sia	%	P'tan	%	Sudan	%	Tunisia	%	Turkey	%	UAE	%
LC & LG	100	LC	90	LC	66	LC	69	LC	25	LC	13	LC	43	LC	12	CA	100	LC & LG	100	LC	40
		LG	3	LG	18	LG	28	LG	40	LG	35	LG	28	LG	7					LG	60
		BFC	5	IC	11			FExc	35	FExc	9	FExc	16	BFC	55						
		Others	2	Others	5	Others	3	Others		Others	25	Others	1	Others	26						
Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100	Total	100
% TA	3	% TA	38	% TA	13	% TA	4	% TA	10	% TA	36	% TA	3	% TA	89	% TA	5	% TA	99	% TA	12

Notes:

- i. LC: Letters of credit; LG: Letters of guarantee; IC: Islamic contracts; FExc: Foreign exchange contract; BFC: Bills for collection, CA: Contia accounts
2. Islamic contracts, which are used in Iran only, is actually a foreign exchange contracts facility.

Sources:

Bahrain: IBB's 1994 annual report; Bangladesh: IBBL's 1993 annual report; Iran: BMI's 1992 annual report; Jordan: JIB's 1993 annual report; Kuwait: KFH's 1993 annual report; Malaysia: BIMB's 1994 annual report; Pakistan: MCB's 1993 annual report; Sudan: El Gharb's 1993 annual report; Tunisia: BEST's 1992 annual report; Turkey: FFI's 1993 annual report; United Arab Emirates: DIB's 1992 annual report.

4.4 Sources and Uses of Funds

Basically there are three main sources of funds for Islamic banks, namely, (i) deposits from customers, (ii) other liabilities, and (iii) shareholders' funds. The breakdown of sources of funds for selected Islamic banks at the end of the reported period is shown in Table 4.6.

IBB, BMI, BIMB, MCB, and FFI are those banks for which the funds deposited by customers constitute about 90% of the total liabilities. The percentage figures for other Islamic banks are within the range of about 60% to 85% of total liabilities. El Gharb of Sudan has the lowest percentage figure, i.e. 59% of the total assets.

With regard to the shareholders' funds, except for BEST with 17% of total liabilities, no bank has shareholders' funds in excess of 7% of total liabilities. Shareholders' funds comprise paid-up capital, various reserves and retained earnings. The majority of the banks have shareholders' funds between 5% and 7% of the total equities and BMI has the lowest figure, i.e. less than 1% of total equities.

Among the Islamic banks which have a relatively high proportion of 'other' liabilities are El Gharb (34%), IBBL (13%), JIB (12%), and DIB (12%). While the bulk of other liabilities for IBBL and DIB is represented by the 'unearned revenue' which is derived from *murabaha* and *musharaka* contracts, for JIB the main item is 'unpaid profit for deposits' to the depositors. In the case of El Gharb, the 'other' liabilities category comprises 'investment deposit share', 'provision for income tax', 'accruals', 'creditors' and 'other credit balances'.

Table 4.6
Sources of Funds of Islamic Banks in Selected Countries (%)

	Bahrain	B'desh	Iran	Jordan	Kuwait	M'sia	P'tan	Sudan	Tunisia	Turkey	UAE
Sources of funds											
Deposit	91	84	92	81	85	87	89	59	74	87	83
SH funds	6	3	*	7	5	7	3	7	17	7	5
Others	3	13	8	10	10	6	8	34	9	6	12
Total Sources	100	100	100	100	100	100	100	100	100	100	100

Notes:

1. * The percentage figure is less than 1%
2. SH funds (shareholder's funds) consists of paid-up capital, reserves, and retained profits.

Sources:

Bahrain: IBB's 1994 annual report; Bangladesh: IBBL's 1993 annual report; Iran: BMI's 1992 annual report; Jordan: JIB's 1993 annual report;
 Kuwait: KFH's 1993 annual report; Malaysia: BIMB's 1994 annual report; Pakistan: MCB's 1993 annual report; Sudan: El Gharb's 1993 annual
 report; Tunisia: BEST's 1992 annual report; Turkey: FFI's 1993 annual report; United Arab Emirates: DIB's 1992 annual report.

How Islamic banks use their funds is represented by the types of assets held, as disclosed in the balance sheet. As presented in Table 4.7, these assets basically belong to five main categories, namely, (i) cash, (ii) financing, (iii) investment, (iv) others, and (v) fixed assets. Cash includes cash in hand, balance with the Central Bank or reserves, and balance with other financial institutions. Financing comprises all loans extended under the principles of *mudaraba*, *musharaka*, *murabaha*, *bai mua'zzal*, *ijara* and *qard hassan*. Investment not only consists of investments in government securities, treasury bills and other Islamic securities (e.g., Islamic bonds and Islamic bankers' acceptances) but also includes investments in subsidiaries and associated companies. Fixed assets include all land and buildings, motor-vehicles, and furniture and fixtures. Assets such as prepayments, other receivables, stationery, stock of commodities, and intangible assets which belong to the bank and cannot be classified into any of the four categories mentioned above, are classified as 'other' assets. Some of the prominent features in terms of uses of funds among the Islamic banks in the selected countries are as follows.

1. There is no standard approach to the use of funds among Islamic banks. As shown in Table 4.7, the variations are reflected not only by the differences in terms of preferences, but also in the percentage of funds allocated for various categories of assets. Except for BIMB, KFH and El Gharb of Sudan which give priority to investments, Islamic banks in other countries concentrate on financing activities. For IBBL and FFI, investment activities are less important and are ranked fifth and fourth respectively out of the five categories mentioned above. Cash is ranked second by six banks, i.e. BMI, IBBL, JIB, BEST, FFI and DIB. The banks which rank cash as third after financing and investment are IBB, MCB, KFH, BIMB and El Gharb of Sudan. Except for IBB of Bahrain, which ranks other assets similar to investment, i.e. second position, most of the banks rank investment or other assets at the fourth position and fixed assets are placed last among the categories of assets by the majority of banks.

2. Amongst the Islamic banks which give top priority to financing activities, FFI and IBB emerged as the top banks with approximately 84% of the total assets being allocated to these activities. For BIMB and KFH, where financing is ranked second, the percentage was 33% and 40% of total assets respectively.
3. In addition to BIMB and KFH, MCB of Pakistan also participated heavily in investment activities. The percentage of investment activities relative to total assets was 53% for BIMB, 47% for KFH and 39% for MCB. The higher percentage in investment activities for Kuwait, Malaysia and Pakistan is due to the fact that the governments of those countries issue securities based on Islamic principles, thus creating an investment avenue for the Islamic banks. This kind of opportunity is not available in other countries. In Sudan, however, the investment made by Islamic banks is not so much in securities but mainly in foreign currencies.
4. Islamic banks in countries where the investment avenue is limited usually keep more funds in cash. Banks such as BIMB, KFH and MCB maintain their cash position at about 11% or 12% of the total assets. JIB has the highest cash percentage, i.e. 34%, followed by IBBL with 33%. The lowest cash holding, i.e. 4% of total assets, is held by IBB of Bahrain.

Table 4.7
The Composition and Ranking of Assets Among the Islamic Banks in Selected Countries

	Bahrain		B'desh		Iran		Jordan		Kuwait		Malaysia		Pakistan		Sudan		Tunisia		Turkey		UAE	
	%	r	%	r	%	r	%	r	%	r	%	r	%	r	%	r	%	r	%	r	%	r
Cash	4	3	33	2	21	2	34	2	11	3	11	3	12	3	16	3	14	2	11	2	23	2
Financing	83	1	58	1	65	1	58	1	33	2	33	2	41	1	25	2	78	1	84	1	74	1
Investment	6	2	*	5	11	3	4	3	47	1	53	1	39	2	31	1	-	-	1	4	2	3
Other assets	6	2	8	3	2	4	2	4	1	4	2	4	7	4	15	4	4	3	2	3	*	5
Fixed assets	1	4	1	4	1	5	2	4	1	4	1	5	1	5	13	5	4	3	2	3	1	4
Total assets (%)	100		100		100		100		100		100		100		100		100		100		100	

Notes:

1. * Less than 0.5 %
2. r: rank

Sources:

Bahrain: IBB's 1994 annual report; Bangladesh: IBBL's 1993 annual report; Iran: BMI's 1992 annual report; Jordan: JIB's 1993 annual report; Kuwait: KFH's 1993 annual report; Malaysia: BIMB's 1994 annual report; Pakistan: MCB's 1993 annual report; Sudan: El Gharb's 1993 annual report; Tunisia: BEST's 1992 annual report; Turkey: FFI's 1993 annual report; United Arab Emirates: DIB's 1992 annual report.

4.5 Accounting Policies

The objective of this section is to highlight the variation in accounting policies among the Islamic banks in preparing their financial statements. While almost all Islamic banks describe some of the important accounting policies in their annual report, there is no such description in the annual reports of BMI, El Gharb and FFI of Turkey.

4.5.1. The Basis of Financial Statement Preparation

Except for JIB and BEST, which do not disclose the basis for their financial statements preparation, Islamic banks in other countries use historical cost convention. Besides stating that they are using historical cost convention, Islamic banks in certain countries have added statements which say that they are observing additional standards imposed by the regulatory authority of those countries. In most cases, there are no explanations given on those additional standards. MCB of Pakistan, for example, reports that the basis of preparing its financial statements is in conformity with the accepted accounting policies of banking institutions in Pakistan. Similarly, IBBL of Bangladesh includes additional provisions which assert that the basis of preparing the statement is subject to the formats prescribed under the Banking Companies Act, 1991 and follows the bank's accounting policies. For KFH of Kuwait, the preparation of statements is in accordance with the Ministerial Order No. 18/90. In this Order, financial statements must be prepared in conformity with International Accounting Standards, as promulgated by the International Accounting Standards Committee. BIMB of Malaysia claim that they use historical cost convention with modification in complying with the principles of *Shariah*. There is, however, no clarification on the subject matter.

4.5.2 Income Recognition

Some Islamic banks do not describe their income recognition policy in their annual reports. Nowhere in the annual report of IBBL, JIB, MCB, and FFI of Turkey is there any statement which indicates the policies adopted by these banks. IBB, KFH, BIMB, BEST and DIB of the United Arab Emirates do disclose their revenue recognition policy. These disclosures, however, are given in general terms.

KFH of Kuwait recognises income from *murabaha* and *ijara* on a time proportion basis, i.e. income from a particular contract will be divided evenly according to the duration of the contract or from the date of disbursement until the loan is fully settled. Rental income and income from government debt bonds are computed on an accruals basis and income from dividends is recognised only when earned. For DIB of the United Arab Emirates, a time proportion basis is used for *murabaha*, *musharaka* (on property) and property rental. Income from *mudaraba* is included when advised by the *mudaraba* manager.

IBB of Bahrain recognises profit on financing contracts (*murabaha* and *musharaka*) when deals are concluded, except for credit contracts which extend beyond one financial period where the profit is distributed on a pro-rata basis over the period of the contracts in order that each financial period is allocated its proportionate share of the profit. Other categories of income are recognised only when cash or payment is received. BIMB uses a single method called 'actuarial' in recognising income its financing activities. The actuarial or cash accounting method is one which records income only when cash is received.

4.5.3 Investment

All banks recorded their investment at cost, less the permanent diminution in value if any. BIMB of Malaysia, however, uses both cost and current value methods. As stated in its 1994 annual report, long-term investments, investment in Malaysian Government Investment Certificates, investments in subsidiaries and investments in unquoted shares are stated at cost less the provision for any permanent diminution in value. Short-term investments are stated either at cost or market value, whichever is lower.

4.5.4 Provision for Doubtful Debts

Islamic banks in Iran, Malaysia, Pakistan, Kuwait and Bahrain are among those that disclose their provision for doubtful debts policy. Generally there are two kinds of provisions created by these banks, i.e. general and specific provisions. The general provision is based on a percentage of the loan portfolio and covers possible losses which are not specifically identified. Specific provisions are made for doubtful loans which have been individually reviewed and specifically identified as bad and doubtful. IBBL, JIB, El Gharb, BEST and DIB of the United Arab Emirates do not specify any policy on this matter but provide a certain sum as provision for doubtful debts.

4.5.5 Fixed Assets and Depreciation

Except for FFI of Turkey, which adopts a current value policy for the valuing of its fixed assets, other Islamic banks use cost minus depreciation charges. Freehold land is not depreciated. Other fixed assets such as buildings, motor vehicles, furniture and equipment are depreciated by equal amounts over their estimated useful lives. BIMB, IBBL and DIB of United Arab Emirates are among the banks which publish the estimated useful lives for various kinds of fixed assets. Both JIB and BEST use fixed

ratios specified by the laws of their countries. JIB of Jordan use ratios specified by the Jordanian Income Tax Department, whereas the annual report of BEST of Tunisia states that the depreciation ratios are according to Tunisian Law.

4.5.6 Allocation of Profit to Depositors

The three banks that disclose the allocation of profits to depositors are IBBL, KFH and BEST of Tunisia. Neither IBBL nor KFH, however, mention how the profit figure is calculated, but rather mention that the amount is based on the discretion of management. BEST of Tunisia adopts the following rules:

a. Income to committed deposit:

Realised profits on committed deposits are distributed according to the percentage of distribution agreed upon.

b. Income to uncommitted deposits:

- i. The profit rates of each kind of deposit are determined according to investment term and invested amount from the total common resources.
- ii. The average yield on investment is calculated by taking into account profits realised during the fiscal year, as well as the average invested funds for the period.
- iii. The profits are distributed between uncommitted deposits and the Bank's own funds.
- iv. The Bank's *mudaraba* share is deducted from profits to both committed and uncommitted deposits according to the percentage of distribution agreed between the Bank and depositor.

Other Islamic banks such as BIMB of Malaysia, JIB of Jordan, and IBB of Bahrain do not disclose their policy on allocation of profit to depositors but publish the rate of profit distributed on various deposit facilities.

4.5.7 Payment for *Zakat*

The banks which mention the payment of *zakat* are BIMB of Malaysia, IBB of Bahrain and DIB of the United Arab Emirates. The payment of *zakat* is made upon approval by the Shariah Supervisory Council of the individual bank. IBBL of Bangladesh, KFH of Kuwait and El Gharb of Sudan do not mention the policy regarding payment of *zakat*, but *zakat* payments are nevertheless made. Other banks, i.e. BMI of Iran, JIB of Jordan, MCB of Pakistan, BEST of Tunisia and FFI of Turkey, are silent about *zakat*.

4.5.8 Other Significant Policies

Since the bulk of funds deposited by customers is based on profit-loss sharing, some Islamic banks adopt policies which specify that the depositors are responsible for the general and administrative expenses. Thus, the profit distributed to the depositors is based on the profit after deduction of those expenses. Islamic banks that adopt this principle are KFH of Kuwait, DIB of the United Arab Emirates, and IBB of Bahrain. In the cases of JIB of Jordan, BIMB of Malaysia, El Gharb of Sudan, BEST of Tunisia, and FFI of Turkey, the banks (shareholders) alone bear all the general and administrative expenses. By sharing the payment of general and administrative expenses, the amounts received by depositors at KFH, DIB and IBB are relatively lower than those at JIB, BIMB, El Gharb, BEST and FFI.