much closer and more cordial than is possible under conventional banking. Finally, the problems of liquidity shortage or surplus would have to be handled differently in Islamic banking, since the ban on interest rules out resort to the money market and the central bank. Chapra suggested alternatives such as reciprocal accommodation among banks without interest payments and creation of a common fund at the central bank into which surpluses would flow and from which shortages could be met without any interest charges.

The literature also discusses the question of central banking in an Islamic framework. The general opinion seems to be that the basic functions of a modern central bank are relevant also for an Islamic monetary system, although the mechanisms may have to be different. Thus, for example, the bank rate instrument cannot be used as it entails interest. Uzair (1982) has suggested adjustments in profit-sharing ratios as a substitute for bank rate manipulations by the central bank. Thus, credit can be tightened by reducing the share accruing to the businessmen and eased by increasing it. Siddiqi (1982) has suggested that variations in the so-called 'refinance ratio' (which refers to the central bank refinancing of a part of the interest-free loans provided by the commercial banks) would influence the quantum of short-term credit extended. Siddiqi has also proposed a prescribed 'lending ratio' (i.e., the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) that can be adjusted by the central bank according to changing circumstances. In this context, reference may also be made to a proposal by Uzair (1982) that the central bank should acquire an equity stake in commercial banking by holding, say, 25 per cent of the capital stock of the commercial banks. The rationale behind this proposal was that it would give the central bank access to a permanent source of income so that it could effectively act as lender of last resort. The discussion of central banking in an Islamic context is somewhat scanty, presumably because Islamic central banking is viewed as too far-fetched an idea, except in Iran and Pakistan.

(Contd...............)

Chapra's model of Islamic banking (Chapra 1982), like Siddiqi's, was based on the mudaraba principle. His main concern, however, centered on the role of artificial purchasing power through credit creation. He even suggested that 'seigniorage' resulting from it should be transferred to the public exchequer, for the sake of equity and justice. Al-Jarhi (1983) went so far as to favor the imposition of a 100 per cent reserve requirement on commercial banks. Chapra was also much concerned about the concentration of economic power private banks might enjoy in a system based on equity financing. He therefore preferred medium-sized banks which are neither so large as to wield excessive power nor so small as to be uneconomical. Chapra's scheme also contained proposals for loss-compensating reserves and loss-absorbing insurance facilities. He also spoke of non-bank financial institutions, which specialize in bringing financiers and entrepreneurs together and act as investment trusts.

Mohsin (1982) has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by banking business alone. Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Mohsin's model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that riba-free banks could coexist with interest-based banks. The point that there is more to Islamic banking than mere abolition of interest was driven home strongly by Chapra (1985). He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of riba, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a social-welfare-oriented rather than a profit-maximizing role. He conceived of Islamic banks as a cross-breed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers. Unlike conventional banks which depend heavily on the 'crutches of collateral and of non-participation in risk' (p. 155), Islamic banks would have to rely heavily on project evaluation, especially for equity-oriented financing. Thanks to the profit-and-loss sharing nature of the operations, bank-customer relations would be mudaraba and shirka (partnership or musharaka as it is now usually called). His model was essentially one based on a two-tier mudaraba financier-entrepreneur relationship, but he took pains to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic examples. He classified the operations of an Islamic bank into three categories: services based on fees, commissions or other fixed charges; financing on the basis of mudaraba and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

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

Strangely, Siddiqi favoured keeping the number of shareholders to the minimum, without advancing any strong reasons. This is contrary to the general consensus which now seems to have emerged with reference to Islamic banks operating on a joint stock company basis, a consensus which incidentally is also in line with the Islamic value attached to a broad equity base as against heavy concentration of equity and wealth. Ironically, Siddiqi thought that interest-free banking could operate successfully 'only in a country where interest is legally prohibited and any transaction based upon interest is declared a punishable offense' (1983b:13). He also thought it important to have Islamic laws enforced before interest-free banking could operate well. This view has not gained acceptance, as demonstrated by the many Islamic banks which operate profitably in 'hostile' environments, as noted earlier.

☆ امام مالک بن انس رحمۃ اللہ علیہ کی ولادت سن ۹۳ ہجری میں اور وفات ۱۷۹ ہجری میں ہوئی ☆

who seek capital from the banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any. It was suggested that banks should cash bills of trade without charging interest, using the current account funds.

The principle of mudaraba based on Shariah was invoked systematically by Uzair (1955). His principal contribution lay in suggesting mudaraba as the main premise for 'interestless banking'. However, his argument that the bank should not make any capital investment with its own deposits rendered his analysis somewhat impractical.

Al-Arabi (1966) envisaged a banking system with mudaraba as the main pivot. He was actually advancing the idea of a two-tier mudaraba which would enable the bank to mobilize savings on a mudaraba basis, allocating the funds so mobilized also on a mudaraba basis. In other words the bank would act as a mudarib in so far as the depositors were concerned, while the 'borrowers' would act as mudaribs in so far as the bank was concerned. In his scheme, the bank could advance not only the capital procured through deposits but also the capital of its own shareholders. It is also of interest to note that his position with regard to the distribution of profits and the responsibility for losses was strictly in accordance with the Shariah.6 Irshad (1964) also spoke of mudaraba as the basis of Islamic banking, but his concept of mudaraba was quite different from the traditional one in that he thought of capital and labour (including entrepreneurship) as having equal shares in output, thus sharing the losses and profits equally. This actually means that the owner of capital and the entrepreneur have a fifty-fifty share in the profit or loss as the case may be, which runs counter to the Shariah position. Irshad envisaged two kinds of deposit accounts. The first sounded like current deposits in the sense that it would be payable on demand, but the money kept in this deposit would be used for social welfare projects, as the depositors would get zero return. The second one amounted to term deposits which would entitle the depositors to a share in the profits at the end of the year proportionately to the size and duration of the deposits. He recommended the setting up of a Reserve Fund which would absorb all losses so that no depositor would have to bear any loss. According to Irshad, all losses would be either recovered from the Reserve Fund or borne by the shareholders of the bank.

A pioneering attempt at providing a fairly detailed outline of Islamic banking was made in Urdu by Siddiqi in 1968. (The English version was not published until 1983.) His Islamic banking model was based on

امام محمد بن ادریس شافعی رحمۃ اللہ علیہ کا سن ولادت ۱۵۰ ہجری اور سن وفات ۲۰۴ ہجری ہے ☆

entrepreneur to sell his output to the bank at a price determined in advance. Islamic banks, in keeping with modern times, have extended this facility to manufactures as well.

It is clear from the above sketch that Islamic banking goes beyond the pure financing activities of conventional banks. Islamic banks engage in equity financing and trade financing. By its very nature, Islamic banking is a risky business compared with conventional banking, for risk-sharing forms the very basis of all Islamic financial transactions. To minimize risks, however, Islamic banks have taken pains to distribute the eggs over many baskets and have established reserve funds out of past profits which they can fall back on in the event of any major loss.

Literature: Theory

It is not possible to cover in this survey all the publications which have appeared on Islamic banking. There are numerous publications in Arabic and Urdu which have made significant contributions to the theoretical discussion. A brief description of these in English can be found in the Appendix to Siddiqi's book on Banking without Interest (Siddiqi 1983a). The early contributions on the subject of Islamic banking were somewhat casual in the sense that only passing references were made to it in the discussion of wider issues relating to the Islamic economic system as a whole. In other words, the early writers had been simply thinking aloud rather than presenting well-thought-out ideas. Thus, for example, the book by Qureshi on Islam and the Theory of Interest (Qureshi 1946) looked upon banking as a social service that should be sponsored by the government like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit-sharing.

Ahmad, in Chapter VII of his book Economics of Islam (Ahmad 1952), envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen money as and when they please. The investment account is based on the mudaraba principle. and the deposits are term deposits which cannot be withdrawn before maturity. The profit- sharing ratio varies from bank to bank and from time to time depending on supply and demand conditions.4 In theory, the rate of return could be positive or negative, but in practice the returns have always been positive and quite comparable to rates conventional banks offer on their term deposits.5

At the investment portfolio end of the scale, Islamic banks employ a variety of instruments. The mudaraba and musharaka modes, referred to earlier, are supposedly the main conduits for the outflow of funds from the banks. In practice, however, Islamic banks have shown a strong preference for other modes which are less risky. The most commonly used mode of financing seems to be the 'mark-up' device which is termed murabaha. In a murabaha transaction, the bank finances the purchase of a good or asset by buying it on behalf of its client and adding a mark-up before re-selling it to the client on a 'cost-plus' basis. It may appear at first glance that the mark-up is just another term for interest as charged by conventional banks interest thus being admitted through the back door. What makes the murabaha transaction Islamically legitimate is that the bank first acquires the asset and in the process it assumes certain risks between purchase and resale. The bank takes responsibility for the good before it is safely delivered to the client. The services rendered by the Islamic bank are therefore regarded as quite different from those of a conventional bank which simply lends money to the client to buy the good.

Islamic banks have also been resorting to purchase and resale of properties on a deferred payment basis, which is termed bai' muajjal. It is considered lawful in fiqh (jurisprudence) to charge a higher price for a good if payments are to be made at a later date. According to fiqh. this does not amount to charging interest, since it is not a lending transaction but a trading one.

Leasing or ijara is also frequently practised by Islamic banks. Under this mode, the banks would buy the equipment or machinery and lease it out to their clients who may opt to buy the items eventually, in which case the monthly payments will consist of two components, i.e., rental for the use of the equipment and instalment towards the purchase price. Reference must also be made to pre-paid purchase of goods, which is termed bai'salam, as a means used by Islamic banks to finance production. Here the price is paid at the time of the contract but the delivery would take place at a future date. This mode enables an purposes and he may share the profits, if any, with the entrepreneur-borrower (mudarib); losses, if any, however, will be borne wholly by the rabbul-mal. This mode of financing, termed mudaraba in the Islamic literature, was in practice even in the pre-Qur'anic days and, according to jurists, it was approved by the Prophet.

Another legitimate mode of financing recognized in Islam is one based on equity participation (musharaka) in which the partners use their capital jointly to generate a surplus. Profits or losses will be shared between the partners according to some agreed formula depending on the equity ratio. Mudaraba and musharaka constitute, at least in principle if not in practice, the twin pillars of Islamic banking. The musharaka principle is invoked in the equity structure of Islamic banks and is similar to the modern concepts of partnership and joint stock ownership. In so far as the depositors are concerned, an Islamic bank acts as a mudarib which manages the funds of the depositors to generate profits subject to the rules of mudaraba as outlined above. The bank may in turn use the depositors' funds on a mudaraba basis in addition to other lawful modes of financing. In other words, the bank operates a two-tier mudaraba system in which it acts both as the mudarib on the saving side of the equation and as the rabbul-mal on the investment portfolio side. The bank may also enter into musharaka contracts with the users of the funds, sharing profits and losses, as mentioned above. At the deposit end of the scale, Islamic banks normally operate three broad categories of account, mainly current, savings, and investment accounts The current account, as in the case of conventional banks, gives no return to the depositors. It is essentially a safe-keeping (al-wadiah) arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time and permits the bank to use the depositors' money. As in the case of conventional banks, cheque books are issued to the current account deposit holders and the Islamic banks provide the broad range of payment facilities - clearing mechanisms, bank drafts, bills of exchange, travellers cheques, etc. (but not yet, it seems, credit cards or bank cards). More often than not, no service charges are made by the banks in this regard.

The savings account is also operated on an al-wadiah basis, but the bank may at its absolute discretion pay the depositors a positive return periodically, depending on its own profitability. Such payment is considered lawful in Islam since it is not a condition for lending by the depositors to the bank, nor is it pre-determined. The savings account holders are issued with savings books and are allowed to withdraw their

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

The Islamic ban on interest does not mean that capital is costless in an Islamic system. Islam recognizes capital as a factor of production but it does not allow the factor to make a prior or pre-determined claim on the productive surplus in the form of interest. This obviously poses the question as to what will then replace the interest rate mechanism in an Islamic framework.

There have been suggestions that profit-sharing can be a viable alternative (Kahf 1982a and 1982b). In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit- sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself that is predetermined.

It has been argued that profit-sharing can help allocate resources efficiently, as the profit-sharing ratio can be influenced by market forces so that capital will flow into those sectors which offer the highest profit- sharing ratio to the investor, other things being equal. One dissenting view is that the substitution of profit-sharing for interest as a resource allocating mechanism is crude and imperfect and that the institution of interest should therefore be retained as a necessary evil (Naqvi 1982). However, mainstream Islamic thinking on this subject clearly points to the need to replace interest with something else, although there is no clear consensus on what form the alternative to the interest rate mechanism should take. The issue is not resolved and the search for an alternative continues, but it has not detracted from efforts to experiment with Islamic banking without interest.

Anatomy

As mentioned earlier, Islam does not deny that capital, as a factor of production, deserves to be rewarded. Islam allows the owners of capital a share in a surplus which is uncertain. To put it differently, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved.

The owner of capital (rabbul-mal) may 'invest' by allowing an entrepreneur with ideas and expertise to use the capital for productive (sayings of the Prophet). The Prophet condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt.2

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

Some scholars have put forward economic reasons to explain why interest is banned in Islam. It has been argued, for instance, that interest, being a pre- determined cost of production, tends to prevent full employment (Khan 1968; Ahmad n.d.; Mannan 1970). In the same vein, it has been contended that international monetary crises are largely due to the institution of interest (Khan, n.d), and that trade cycles are in no small measure attributable to the phenomenon of interest (Ahmad 1952; Su'ud n.d.). None of these studies, however, has really succeeded in establishing a causal link between interest, on the one hand, and employment and trade cycles, on the other. Others, anxious to vindicate the Islamic position on interest, have argued that interest is not very effective as a monetary policy instrument even in capitalist economies and have questioned the efficacy of the rate of interest as a determinant of saving and investment (Ariff 1982). A common thread running through all these discussions is the exploitative character of the institution of interest, although some have pointed out that profit (which is lawful in Islam) can also be exploitative. One response to this is that one must distinguish between profit and profiteering, and Islam has prohibited the latter as well.

Some writings have alluded to the 'unearned income' aspect of interest payments as a possible explanation for the Islamic doctrine. The objection that rent on property is considered halal (lawful) is then answered by rejecting the analogy between rent on property and interest on loans, since the benefit to the tenant is certain, while the productivity of the borrowed capital is uncertain. Besides, property rented out is subject to physical wear and tear, while money lent out is not. The question of erosion in the value of money and hence the need for indexation is an interesting one. But the Islamic jurists have ruled out compensation for erosion in the value of money, or, according to Hadith, a fungible good must be returned by its like (mithl): 'gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, and hand to hand ...'.3

are afoot to open six new branches a year so that by 1990 the branch network of BIMB will total thirty-three (Man 1988).

Reference should also be made to some Islamic financial institutions established in countries where Muslims are a minority. There was a proliferation of interest-free savings and loan societies in India during the seventies (Siddiqi 1988). The Islamic Banking System (now called Islamic Finance House), established in Luxembourg in 1978, represents the first attempt at Islamic banking in the Western world. There is also an Islamic Bank International of Denmark, in Copenhagen, and the Islamic Investment Company has been set up in Melbourne, Australia.

Rationale

The essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra 1982), it nevertheless derives its specific rationale from the fact that there is no place for the institution of interest in the Islamic order.

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

The prohibition of riba is mentioned in four different revelations in the Qur'an.1 The first revelation emphasizes that interest deprives wealth of God's blessings. The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third revelation enjoins Muslims to stay clear of interest for the sake of their own welfare. The fourth revelation establishes a clear distinction between interest and trade, urging Muslims to take only the principal sum and to forgo even this sum if the borrower is unable to repay. It is further declared in the Qur'an that those who disregard the prohibition of interest are at war with God and His Prophet. The prohibition of interest is also cited in no uncertain terms in the Hadith sharing financial assistance to member countries. The IDB operations are free of interest and are explicitly based on

Shariah Principles

In the seventies, changes took place in the political climate of many Muslim countries so that there was no longer any strong need to establish Islamic financial institutions under cover. A number of Islamic banks, both in letter and spirit, came into existence in the Middle East, e.g., the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Sudan (1977), the Faisal Islamic Bank of Egypt (1977), and the Bahrain Islamic Bank (1979), to mention a few. The Asia-Pacific region was not oblivious to the winds of change. The Philippine Amanah Bank (PAB) was established in 1973 by Presidential Decree as a specialized banking institution without reference to its Islamic character in the bank's charter. The establishment of the PAB was a response by the Philippines Government to the Muslim rebellion in the south, designed to serve the special banking needs of the Muslim community. However, the primary task of the PAB was to assist rehabilitation and reconstruction in Mindanao, Sulu and Palawan in the south (Mastura 1988). The PAB has eight branches located in the major cities of the southern Muslim provinces, including one in Makati (Metro Manila), in addition to the head office located at Zamboanga City in Mindanao. The PAB, however, is not strictly an Islamic bank, since interest-based operations continue to coexist with the Islamic modes of financing. It is indeed fascinating to observe that the PAB operates two 'windows' for deposit transactions, i.e., conventional and Islamic. Nevertheless, efforts are underway to convert the PAB into a full-fledged Islamic bank (Mastura 1988).

Islamic banking made its debut in Malaysia in 1983, but not without antecedents. The first Islamic financial institution in Malaysia was the Muslim Pilgrims Savings Corporation set up in 1963 to help people save for performing hajj (pilgrimage to Mecca and Medina). In 1969, this body evolved into the Pilgrims Management and Fund Board or the Tabung Haji as it is now popularly known. The Tabung Haji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Shariah, but its role is rather limited, as it is a non-bank financial institution. The success of the Tabung Haji, however, provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB) which represents a full- fledged Islamic commercial bank in Malaysia. The Tabung Haji also contributed 12.5 per cent of BIMB's initial capital of M$80 million. BIMB has a complement of fourteen branches in several parts of the country. Plans

Islamic Banking

By : Mohamed Ariff, University of Malaya

Islamic banking is a new phenomenon that has taken many observers by surprise. The whole banking system has been islamized in both Iran and Pakistan. In addition, there are some thirty Islamic banks in operation in other parts of the globe, including the Jeddah-based Islamic Development Bank (IDB) but excluding numerous non-bank Islamic financial institutions (see Appendix). What is more, the speed with which Islamic banks have sprung up and the rate at which they have progressed make it worth-while to study them systematically. An attempt is made in this paper (a) to survey the growing literature on Islamic banking, in particular (b) to trace the growth and development of Islamic banking, and (c) to highlight its salient characteristics.

Contents

Evolution

The first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967 (Ready 1981), by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi 1988). Thus, they functioned essentially as saving- investment institutions rather than as commercial banks. The Nasir Social Bank, established in Egypt in 1971, was declared an interest-free commercial bank, although its charter made no reference to Islam or Shariah (Islamic law).

The IDB was established in 1974 by the Organization of Islamic Countries (OIC), but it was primarily an inter-governmental bank aimed at providing funds for development projects in member countries. The IDB provides fee- based financial services and profit-