Islamic Banking: Theory, Practice and Evaluation

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1. Introduction

Banks are among the most important financial institutions in a modern economy. They perform certain vital functions for society. One of these is their role of financial intermediation: channelling funds from savers to entrepreneurs. Conventional commercial banks provide financial intermediation services on the basis of interest (charged and paid) on both the assets and the liabilities sides. Since interest is prohibited in Islam, Islamic banks have developed several alternative modes through which savings are mobilized and passed on to entrepreneurs. None of these involves interest. They take the form of either risk-and-reward sharing or trading in commodities/assets. Islamic banks also provide other services generally provided by conventional institutions, such as payment services, transfer of funds, insurance, fund management etc., through contracts which are compatible with Islamic rules. Islamic banking has gained wide acceptance and has succeeded in making inroads into the financial markets around the globe.

Islamic banking does not only fulfill the religious requirement for Muslims, but also broadens the choice-set available to other clients by offering both sales-based finance as well as products based on the sharing of risks and returns. The mix of fixed and variable return modes offered by Islamic banks can exert a healthy effect on the efficiency and stability of the financial system. Islamic banking is expected to contribute to greater allocative efficiency[1], financial stability,[2] growth[3] and social justice[4]. In a

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[1] See for example Zarqa (1982)

[2] See Al-Jarhi in K. Ahmed (1980); Zarqa (1983)

[3] See Al-Jarhi in Iqbal and Ahmad (2005)

world beset with financial crises, these strengths inherent in Islamic banking should offer a new ray of hope for achieving the cherished goal of systemic growth with stability.

The experience of the last 30 years has shown that Islamic banking is a viable, dependable and well-supervised activity. It is just another way of performing the financial intermediation function. Islamic banks are subject to the same regulatory standards and fall under the purview of the same supervisory authorities as conventional banks. In addition they have to comply with the Islamic rules which imply that their overall legal and supervisory environment is more stringent. In brief, Islamic banking adds a healthy dimension to the international financial system.

2. Why Islamic Banking is Needed?

In any economy, there is a need to transfer funds from savers to investors because people who save are frequently not the same people who have the ability to exploit the profitable investment opportunities. This function is performed through the process of financial intermediation in the financial markets. Financial intermediation enhances the efficiency of the saving/investment process by eliminating the mismatches inherent in the needs of surplus and deficit units with respect to size, duration, liquidity and risk profiles. The process involves the creation of a variety of financial assets and liabilities with different characteristics to cater for different needs of savers and the ultimate users of funds. Financial intermediaries are also in a better position to collect information about investment opportunities, which is crucial for efficient allocation of society's resources.

The functions that the banks perform are important whether the economy concerned is secular or Islamic. People need banking services. However, conventional banks perform their borrowing and lending activities and most other functions on the basis of fixed interest. In an Islamic economy, both giving and taking of interest is prohibited. As a matter of fact, interest is prohibited by most religions, including Christianity and Judaism[5]. Now, since the banking services are needed but interest is prohibited, Islamic economies have to find alternative ways of performing various banking functions. This requirement provides the rationale of Islamic banking.

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[4] See Chapra (1985)

[5] For evidence see Mills and Presley (1999) pp.101-113 and Chapra (1985) pp. 221-222. Also see article on 'Usury' in the Encyclopaedia of Religion and Ethics, edited by James Hastings (New York: Chalres Scribner's Sons, n.d.) vol.12, pp.548-58.

3. How Does an Islamic Bank Work?

Even though Islamic banks emerged in response to the market needs of Muslim clients, they are not religious institutions *per se*. Like other banks, they are profit seeking business institutions. While it is the preferred way of banking for one fifth of humanity, it offers a wider choice of financial products to all.

An Islamic bank is a deposit-taking institution whose functions include all currently known banking activities. On the liabilities side, it mobilizes funds on the basis of *mudaraba* (profit-sharing) or *wakalah* (as an agent charging a fixed fee for managing funds). On the assets side, it makes finance available on a profit-and-loss sharing basis or through the purchase of goods (on cash) and their sale (on credit) or other trading, leasing and manufacturing activities. It plays the role of an investment manager for the owners of deposits, except a part of demand deposits which are treated as interest-free loans from the clients to the bank and are guaranteed to be repaid in full. Such deposits neither share in risk nor reward. Equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations.[6] In this sense, Islamic banks are similar to universal banks operating in several European countries. An Islamic bank shares its net earnings with its depositors (other than current accounts / demand depositors) in a way that depends on the size and time-to-maturity of the deposits.

4. Potential Benefits of Islamic Banking[7]

Several potential benefits can arise from operations of Islamic banking model. These include:

i) The range of contracts available to savers and entrepreneurs is widened. The menu ranges from low risk trade-linked products to high risk-sharing contracts.

ii) The financial system is enriched by the establishment of financial institutions with different *modus operandi*. This diversity enhances the stability of the financial system because the behavioural characteristics of different types of banks are likely to vary.

iii) Competition among alternative banking models is expected to increase the efficiency of the financial system.

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[6] The most important financial products that can be used by an Islamic bank are given in Annexure 1.

[7] Iqbal (2005)

iv) The financial needs of Muslims can be met in accordance with their faith. Since the public's acceptance of the services provided by the industry play a vital role in creating stable and efficient markets, plurality and inclusiveness are important for the development of financial markets.

v) The allocation of financial resources on the basis of profit-and-loss sharing (PLS) gives maximum weight to the profitability of investment as compared with credit worthiness in the conventional system. Such allocation of resources is expected to be more efficient than that on the basis of interest.

vi) As a result of PLS contracts, the liabilities side of the balance sheet tends to become symmetrical with the assets side. This helps making Islamic banks less vulnerable to external shocks and insolvency.

vii) The liability to share bank losses by investment depositors motivates them to be more vigilant about the operations of their banks and to demand greater transparency and more effective audit. Banks are also under pressure to evaluate their clients' projects more carefully and to monitor the risks more effectively.

viii) Since in the case of both profit-sharing and sale-based contracts, banks assets are created in response to investment opportunities in the real sector of the economy, and all financing is linked to commodities or assets, the real factors related to the production of goods and services (rather than speculative manoeuvres) become the prime determinants of the rates of return.

ix) Debt creation in Islamic finance is generally not possible without the backing of goods and services. Monetary expansion would thus tend to take place in step with the growth of the real economy. This is expected to control inflationary pressures. Destabilizing speculation would also be significantly curtailed as would the erratic and mass movement of short-term funds.

x) Like 'Ethical Funds', Islamic banks do not provide finance to projects considered socially undesirable. That introduces greater social responsibility.

5. Islamic Banking in Practice[8]

When commercial banking emerged after the industrial revolution, Muslim masses refrained to a very significant extent from dealing with commercial banks. However, growing needs of traders, industrialists and other entrepreneurs in rapidly monetizing economies were pressing. The Muslim economists and banks took up the challenge of developing alternative models of financial intermediation. Valuable theoretical work was done in early 19th century. At that time most of the Muslim world was under colonial rule. When Muslim countries gained their independence after the World War II, practical experiments in interest-free financing started at a modest scale and gradually expanded in scope.

While credit societies and cooperatives working on interest-free basis, existed in several Muslim countries even during the colonial period, the semblance of banking institutions started emerging in early 1960s. A pioneering experiment of putting the Islamic principles governing financial dealings into practice was conducted in Mit-Ghamr, Egypt, from 1963-1967. Deriving inspiration from the idea of German saving banks, the Mit-Ghamr initiative mobilized small savings from the rural sector largely through savings accounts. No interest was paid to the account holders. However, as an incentive they were eligible for small short-term interest-free loans for productive purposes. They were allowed to withdraw their deposits on demand. In addition, investment accounts on the basis of profit sharing were also introduced. The funds so mobilized were invested on the basis of profit-sharing with entrepreneurs.

The first interest-free institution with “bank” in its name, Nasser Social Bank, was also established in Egypt in 1971. This was the first time that a government in a Muslim country showed an interest in incorporating an interest-free institution. Even though the objectives of the Nasser Social Bank were mainly social, such as providing interest-free loans to the poor and needy; scholarships to students; and micro-credits to small projects on profit-sharing basis; the involvement of a public authority in interest-free banking sent important signals to Muslim businessmen having surplus funds. A group of such businessmen took the initiative of establishing the Dubai Islamic Bank in 1975 in Dubai, United Arab Emirates (UAE). This was the first Islamic Bank established on private initiative. However, the official support was crucial with the governments of UAE and Kuwait contributing respectively 20% and 10% of the capital.

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[8] For a more detailed coverage of Islamic banking in practice, see Iqbal and Molyneux (2005).

The most important development in the history of Islamic banking took place with the establishment of the Islamic Development Bank (IDB) in 1975. The IDB was established as an international financial institution in pursuance of the declaration of intent issued by a conference of finance ministers of Islamic countries held in Jeddah, Saudi Arabia in December 1973. The declaration was signed by the representatives of twenty-three member countries of the Organization of the Islamic Conference (OIC). The second conference of finance ministers, held in Jeddah, in August 1974, adopted the Articles of Agreement establishing the Islamic Development Bank. The inaugural meeting of the Board of Governors of the IDB took place in Riyadh, Saudi Arabia, in July 1975 and the Bank started functioning on 20 October 1975.

The period between 1975 and 1990 was the most important period in the history of development of Islamic financial industry. During this period, it matured into a viable alternative model of financial intermediation. It won respect and credibility in terms of both theoretical developments and practical experiences. On the one hand, several financial products compatible with Islamic principles were developed and on the other hand, Islamic banks showed good results in practice while using these products. The period was not only marked by establishment of a large number of Islamic financial institutions in the private corporate sector under different socio economic milieu, but also witnessed the expression of intent from three countries, namely, Pakistan, Iran and Sudan, to gradually eliminate interest from their entire economies and substituting it with a complete banking systems based on Islamic principles. Several practical steps were also taken in these countries towards achieving that objective. Even more important was the fact that several important multinational banks started offering Islamic financial products. These included Hong Kong and Shanghai Banking Corporation (HSBC), Chase Manhattan, Grindlays and Citibank to name only a few. That was a clear recognition of the viability of the new model and its acceptance by international players. The International Monetary Fund and the World Bank also recognized the importance of Islamic financial products as means of financial intermediation and produced papers to that effect[9].

[9] See for example, Haque and Mirakhor (1986), Iqbal and Mirakhor (1987) and Karsten (1982).

Broadly speaking two different approaches were followed by Islamic countries for the expansion of Islamic banking, viz., state-sponsored growth and development of Islamic banking in a competitive framework.

6. Country Experiences With Islamic Banking

6.1 Pakistan

The process of economy wide Islamisation of the banking system in Pakistan was initiated soon after a declaration by the then President of Pakistan in February 1979 that the Government planned to remove interest from the economy within a period of three years and that a decision had been taken to make a beginning in this direction with the elimination of interest from the operations of three specialized financial institutions, House Building Finance Corporation, National Investment Trust and the mutual funds of the Investment Corporation of Pakistan.

For the conversion of the operations of commercial banks to a non-interest basis a gradual approach was adopted. To begin with, steps were taken in January 1981 to set up separate counters for accepting deposits on profit/loss sharing (PLS) basis in all the domestic branches of the five nationalized commercial banks. The parallel system, in which savers had the option to keep their money with the banks either in interest bearing deposits or PLS deposits, continued to operate till the end of June 1985. As from 1st July 1985, no banking company was allowed to accept any interest bearing deposits except foreign currency deposits which continued to earn interest. As from that date, all deposits accepted by banking companies shared in the profit and loss of the bank except deposits in current account on which no interest or profit was given and whose capital sum was guaranteed. The central bank of the country issued instructions specifying twelve modes of financing in which funds mobilized by the banks could be employed. However, in practice, banks relied almost entirely on *murabaha* (mark-up) and buy-back arrangements.

A beginning in the direction of introducing the *mudaraba* technique of financing was made in June, 1980 when a law was promulgated under which companies, banks and other financial institutions could register themselves as *mudaraba* companies and mobilize funds through the issuance of *mudaraba* certificates. Funds obtained through a *mudaraba* contract could only be used in such businesses which were permitted under the *sharī´ah*, and needed prior clearance from a Religious Board established by the government specifically for the purpose.

Though a number of steps were taken for the elimination of interest from the financial sector in Pakistan, the process of Islamisation was slow and selective. Nothing was done to eliminate interest from government transactions. Another disappointing feature of the situation was the lack of any notable progress in the transition to profit/loss sharing on the assets side of the banking system. Furthermore, no institutional mechanism was created for a continuous scrutiny of the operating procedures of banks and other financial institutions from the *sharī´ah* point of view. Individual scholars who examined these operating procedures pointed out several areas where the actual banking practices showed deviation from *sharī´ah*. In December 1991, the Federal Shariat Court, in one of its judgments, held that the system of mark-up financing as being practiced by banks was not in conformity with the injunctions of Islam. It also took exception to a number of other practices prevailing in the banking sector. The court instructed the government to repeal/correct all un-Islamic provisions and practices. The government filed an appeal against this decision in the Supreme Court, the apex judicial body. After a long delay, the Supreme Court took up hearing of this and some other similar appeals in 1998. It gave its judgment in 1999 in which it rejected the government appeal and endorsed most of the sections of the Federal Shariat Court judgment. The court gave the government a time frame ending June 2001 to correct objectionable practices identified by the Federal Shariat Court and the Supreme court itself while hearing the case. Later, on an appeal from the Government, the Court extended this deadline by one year. In compliance with that judgment, the government set up a Commission to devise a strategy for implementing the requirements of the judgment. The Commission submitted its report to the Government, but in the meanwhile one bank affected by the Supreme Court decision, filed a review petition. In 2002, the Court reversed its earlier decision and referred the case back to the Federal Shariat Court for a fresh hearing which has not started until now (2006). In the meanwhile, the Government has decided to follow a model of a mixed system whereby conventional and Islamic banking can function side by side. Until the end of 2005, the Central Bank had given banking licences to three Islamic banks. In addition, all commercial banks are entitled to open Islamic windows permission for which is granted on case-by-case basis. In April 2004, the Sharī´ah Board of the Central Bank approved the essentials of Islamic modes of financing to ensure compliance with minimum *sharī´ah* standards by banks conducting Islamic banking in Pakistan. In addition, model agreements for various Islamic modes of financing were developed and announced with the dual objective of facilitating the existing Islamic banking sector and the

potential market players to use Islamic banking products and to create general awareness about Islamic banking products.

6.2 Iran

A new banking law, the "Law for Usury-Free Banking Operations", was enacted in Iran in August 1983 to replace interest based banking by interest free banking. The law required the banks to convert their deposits to an interest-free basis within one year, and their other operations within three years, from the date of the passage of the law, and specified the types of transactions that must constitute the basis for asset and liability acquisition by banks. The law also specified the responsibilities of the central bank under the new system and the mechanics of central bank's control over the banking system.

The law allows the banks to accept three types of deposits, viz., *qarḍ al-ḥasan* deposits, general term investment deposits and project-specific investment deposits. On the asset side, the law provides thirteen different modes of contract, through which finance can be provided. Yasseri (2002) gives operational details of some of these modes. He points out that Iranian banks' most popular contract is instalment sales, followed by *musharaka* (civil), *musharaka* (equity), *mudaraba*, *salaf* (*salam*), *qarḍ al-ḥasan*, direct investment, *jualah* and hire purchase.

One important feature of Islamic banking in Iran is that banks are obliged to earmark a portion of their resources for grant of *qarḍ al-ḥasan* to help achieve the socio-economic objectives set out in the constitution of the country. In addition to banks, a number of charity organizations have also been established under government patronage to grant *qarḍ al-ḥasan*. Besides *qarḍ al-ḥasan*, banks are authorized to extend financial assistance for productive ventures on a profit/loss sharing basis in accordance with the principles of *mudaraba* and *musharaka*. Banks are allowed to provide part of the capital of a new joint stock company and also to purchase shares of existing joint stock companies. Banks are authorized to provide working capital financing to productive units by purchasing raw materials, spare parts and other items on their request for sale to them on the basis of deferred payment in instalments. Purchase of machinery and equipment for sale to their clients on a deferred payment basis is also allowed.

Studies on the progress made in the implementation of the new system show that banks have, in general, adapted well to the new procedures. Problems have been encountered, however, in moving away from traditional short-term trade financing operations and toward profit-sharing

medium and long-term financing operations. It was expected that with the passage of time banks would increase their involvement in *mudaraba* and *musharaka* financing but this expectation has not been fulfilled. No attempt has been made so far to Islamisize international banking and financial operations. In addition, the government continues to borrow from the banks on the basis of a fixed rate of return.[10] It has also been pointed out that some banking practices in Iran are at variance with the practice of Islamic banking in other countries.[11] A number of studies refer to conscious efforts made in recent years to reorient the activities of banks in Iran to achieve Islamic socio-economic objectives.[12] The banking system has been used as an instrument of restructuring the economy, away from services and consumption toward production. Bank financing to the services sector has been drastically curtailed. Banks have reduced financing for the production of luxury goods and commodities with large import content, while financial assistance for the production of necessities and intermediate goods has been appreciably increased. Financing facilities for the agricultural sector have been considerably expanded. The banking system has also been used as an instrument of income redistribution through the provision of *qarḍ al-ḥasan* loans to low income groups, financing the building of low cost houses, and provision of financing for small scale agro business and industrial cooperatives often without stringent collateral requirements.

6.3 Sudan

The process of the economy-wide Islamisation of the banking system in Sudan has not been smooth and steady. The first attempt to Islamise the entire banking system was made in 1984 when a presidential decree was issued directing all commercial banks to stop interest-based dealings with immediate effect and to negotiate the conversion of their then existing interest-bearing deposits and advances into Islamically acceptable forms. Foreign transactions were allowed to be continued on the basis of interest temporarily. It is reported that this sudden change forced the banks to

[10] In one of the studies it is stated: "In the case of the Islamic Republic of Iran, it has been decreed that financial transactions between and among the elements of the public sector, including Bank Markazi and commercial banks that are wholly nationalised, can take place on the basis of a fixed rate of return; such a fixed rate is not viewed as interest. Therefore, the Government can borrow from the nationalised banking system without violating the injunction of the Law." See, Iqbal, Zubair and Abbas Mirakhor (1987), p.24.

[11] A case in point is the treatment of investment deposits. In Iran, the law allows the nominal value of such deposits to be guaranteed while such a guarantee is not considered compatible with Islamic teachings in other countries.

[12] See Mirakhor, Abbas in Chibli Mallat (1988), p.55.

adopt the nearest Islamic alternative available that is *murabaha* which soon constituted 90 percent of their financial operations. It is also reported that the banks applied Islamic financing techniques only formally in their ledger books and in the reports submitted to the Central bank of the country. Policy makers in the Central bank were also discontented with the procedure of transforming the banking system. They considered it as a mere political decision imposed by the government without being preceded by adequate detailed studies."[13] This experiment with economy-wide Islamisation of the banking system came to an end in 1985 with the change in government. The Government revived the process in May 1990 by reactivating an existing Islamic banking law. It issued a more comprehensive law in 1992 which envisioned an economy-wide Islamisation of the financial system including the government sector. Reports indicate that the effort is much more earnest and much better organized this time. Now all banks are using Islamic modes of finance. An important development worth mentioning is the attempt being made to eliminate interest from the government sector also. Other countries have found this a hard nut to crack. The government of Sudan has launched two Funds based on the principle of *musharaka* to mobilize resources for the public sector. The first is, the Government *Musharaka* Certificate (GMC). It is an instrument that enables the government to raise funds through issuance of securities that promise the investor a negotiable return linked to developments in government revenue in return for their investment in the provision of general government services. The other is Central Bank *Musharaka* Certificate (CMC). This is an equity-based instrument that is issued against the government (or Central bank) ownership in commercial banks. Under CMC, the Central bank becomes a partner with the investors in profits of the underlying assets. The distribution of profit between the Central bank and the investors is negotiable and the Certificate can be sold on the secondary market to another bank or the Central bank. While GMC is still operating, CMC has been temporarily discontinued.

6.4 Bahrain

The Kingdom of Bahrain was amongst the first to recognize the importance of the concept of Islamic banking and finance and as a consequence has been both supportive of the development of the industry in general and welcoming to the new institutions in particular. Consequently, Bahrain has gathered a concentration of specialist Islamic institutions on its shores. The first Islamic bank in Bahrain was established

[13] Osman Ahmed in Rodney Wilson ,ed., (1990), p.77.

in 1979, when Bahrain Islamic Bank was licensed. Since then, the sector has grown considerably. Now Bahrain has the largest number of Islamic financial institutions not only in the Gulf but anywhere in the world. The Kingdom is playing host to 26 Islamic banks and financial institutions, five industry-support organizations, six Islamic insurance companies and 34 Islamic mutual funds. A comprehensive prudential set of regulations for Islamic banks was introduced in early 2000 by the Bahrain Monetary Agency (BMA). This is referred to as the Prudential Information and Regulations for Islamic Banks (PIRI) framework. The framework covers areas such as capital adequacy, asset quality, management of investment accounts, corporate governance and liquidity management.

Within such an environment, the Islamic financial industry in Bahrain will be able to enjoy sustainable growth based upon strong investor and customer confidence, attractive product design and expanding markets. Much is already in place. The Bahrain Monetary Agency's statutory responsibility as the sole regulator for the financial sector and the sector's adherence to the PIRI framework ensures that Islamic institutions will continue to operate according to standards comparable to those of the conventional financial sector.

Product innovation continues apace. The *ijarah* and *salam ṣukūk* are now firmly established and the BMA is fully committed to a rolling program of further issues as an integral part of the development of Bahrain as an international Islamic *ṣukūk* market. These initiatives have been matched on their part by the private sector.

6.5 Malaysia

The Islamic financial system that has developed in Malaysia over the last two decades is emerging as a comprehensive Islamic financial system that operates in parallel with, and is able to compete on an even keel with the more entrenched conventional financial system. The development of Islamic finance as an important niche activity in Malaysia's International Offshore Financial Centre in Labuan also complements the development of the domestic Islamic financial market.

The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) that came into effect on 7 April 1983. The IBA provides Bank Negara Malaysia (BNM) with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the Government of Malaysia to issue Government Investment

Certificates (GIC), which are government securities issued based on *sharī´ah* principles. As the GIC are regarded as liquid assets, the Islamic banks can invest in the GIC to meet the prescribed liquidity requirements as well as to invest their surplus funds.

The first Islamic bank established in the country was Bank Islam Malaysia Berhad (BIMB) which commenced operations on 1 July 1983. BIMB proved to be a viable banking institution with its activity expanding rapidly throughout the country with a network of 80 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992. On 1st October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhad (BMMB) commenced operations. The establishment of BMMB was the effect of the spin-off following the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (Malaysia) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to BBMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to BOCB accordingly. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia.

Recognizing that like any banking system, an Islamic banking system requires three vital elements to qualify as a viable system i.e. a large number of players; a broad variety of instruments; and an Islamic money market, BNM has adopted a step-by-step approach to achieve the above objectives. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nation-wide basis, with as many players as possible and to be able to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Following from the above, on 4 March 1993 BNM introduced a scheme known as Skim Perbankan Tanpa Faedah (Interest-free Banking Scheme) or SPTF in short. More than 20 banks are now offering Islamic banking services. In addition, there are more than 50 Islamic investment funds. The Malaysian Financial Sector Master Plan launched in 2001 is the blueprint for the development of the financial sector over a 10-year period in Malaysia. The plan places importance on the development of Islamic

banking and the *takaful* sector as an important component in the financial system.

To ensure the sound and stable development of the Islamic financial industry, it needs to be supported by a strong regulatory and supervisory framework. To fulfil this requirement, the Islamic Financial Services Board (IFSB) was established in 2002. The IFSB is an international body hosted by Malaysia. It has the important mandate of developing the prudential standards in accordance with the unique features of the Islamic financial institutions.

7. Islamic Banks Working in Competitive Environments

There are around 115 Islamic banks (as per data of 2002) working in the private sector, excluding those in Iran and Sudan, which have declared their intention to convert their entire banking sector to Islamic banking.[14] These institutions are spread in a number of countries and continents. The geographical distribution of these Islamic banks is given in Table 1.

Table 1: Islamic Banks by Regions (2002)

Region	**Number of Institutions**	**%**
South and South East Asia	25	22
G.C.C.	56	50
Other M.E.	23	20
Africa	5	4
Rest of the World	5	4
TOTAL	**115**	**100**

Source: Islamic Banking Information System (IBIS), under construction at the Islamic Research and Training Institute, Jeddah.

[14] There are 17 Islamic banks in Iran and 29 in Sudan. Thus the total number of Islamic banks in the world is 161. This number does not include Islamic windows in conventional banks.

These figures show that the largest number of Islamic banks is in the Gulf Cooperation Council (GCC) countries followed by Asian countries and then by other Middle-Eastern countries. Arab World is the cradle of Islamic banking as 70 percent of Islamic banks are located there.

Saudi Arabia is the largest market for Islamic finance in terms of size. The largest Islamic bank in the world, Al Rajhi Banking and Investment Corporation, is based in Saudi Arabia. The bank had $ 20.8 billion in assets at the end of 2004. In addition, almost all other banks operating in Saudi Arabia are offering Islamic products besides their conventional operations. Saudi Arabia is also home to the largest concentration of Islamic funds. The most important Islamic banking institution, the Islamic Development Bank (IDB), is also headquartered in Saudi Arabia.

The Islamic Development Bank is a Multilateral Development Bank serving the Muslim countries. Its present membership stands at 57 countries. Its purpose is to foster economic development and social progress of member countries and Muslim communities, individually and collectively, in accordance with the principles of the *sharī´ah*. In order to meet the growing and diverse needs of its member countries, the Bank has established a number of institutions and funds with distinct administrative arrangements and operational rules. These entities and funds, affiliated with the Bank, enable the IDB to mobilize supplementary financial resources in line with the *sharī´ah* principles and to focus on those functions and activities, which cannot be covered under its normal financing arrangements. With these affiliated entities and funds, the Bank has evolved over time into a group called the IDB Group.

8. Evaluation of Performance and Efficiency of Islamic Banking

Several empirical studies are now available which have examined the performance and efficiency of Islamic banks. Earlier studies, due to data limitation relied more on descriptive statistics. As more data became available, several studies using more rigorous statistical techniques were conducted. One of the earlier studies, (Iqbal: 2001) employed growth rates and ratio analysis for 1990-98 period in a comparative framework using a sample of 12 Islamic banks and 12 conventional banks from 10 countries. The sample was drawn from countries where Islamic banking was most active. The study arrived at the following results:

i) Islamic banking industry showed higher rates of growth in terms of key variables as compared to conventional banks.

ii) Evaluation of the performance of Islamic banks through a number of key ratios yielded fairly satisfactory results. In general, Islamic banks were found to be well capitalized and profitable. They also seemed to be making an effective use of the resources at their disposal.

iii) When compared with conventional banks, Islamic banks as a group out-performed the former in almost all areas. However considerable variations were found among Islamic banks in terms of their growth and performance indicators.

For the purposes of this research, we have updated until 2002 the results of that study with a small change in sample. The reason for that change is that one Islamic bank and one conventional bank out of the twelve banks used in the earlier study[15] merged with other financial institutions and hence their time series was not comparable. Therefore, these two banks and their counterparts from the other Group were removed from the sample. The updated results are given in Tables 2 and 3.

Table 2: Comparative Annual Growth Rates (%)

	Total Equity		**Total Deposits**		**Total Investments**		**Total Assets**	
	Islamic Banks	**Conven-tional Banks**	**Islamic Banks**	**Conven-tional Banks**	**Islamic Banks**	**Conven-tional Banks**	**Islamic Banks**	**Conven-tional Banks**
1990-94[16]	7.9	6.4	9.3	3.1	11.3	-0.8	9.3	4.8
1994-98	12.9	4.0	5.8	5.7	7.3	7.7	7.1	5.4
1998-02	7.3	2.7	13.0	5.7	11.2	7.3	11.7	5.5

[15] In 2000 the Faysal Islamic Bank of Bahrain merged with Islamic Investment Company of the Gulf. Therefore, Faysal Islamic Bank of Bahrain and its counterpart conventional bank, National Bank of Bahrain were excluded from the sample. Similarly, in 2001 one of the conventional banks included in the earlier study's sample, The Pacific Bank Berhad, was acquired by The Malayan Banking Berhad. Therefore, The Pacific Bank and its counterpart Islamic bank, Bank Islam Malaysia Berhad were also excluded from the sample.

[16] Reproduced from Iqbal 2001. Details on sample can also be seen there.

Table 3: Comparative Ratios (%)

Ratios[17]	1990-94[18]		1994-98		1998-02	
	Islamic Banks	Conven-tional Banks	Islamic Banks	Conven-tional Banks	Islamic Banks	Conven-tional Banks
Capital Asset Ratio	9.3	9.0	11.8	8.9	12.2	8.7
Liquidity Ratio	20.2	27.7	14.6	38.7	14.2	32.02
Deployment Ratio	92.2	75.8	96.6	63.9	97.2	69.2
Cost/ Income Ratio	55.9	NA	50.9	60.8	56.1	66.4
ROA	1.9	NA	2.3	1.4	2.2	1.4
ROE	19.9	NA	19.2	8.9	18.0	8.7

It can be seen that despite a slight variation in the sample and change of period of analysis the results arrived at in Iqbal 2001 still hold, which gives us the confidence that those results are quite robust.

In a similar study, Bashir (2001) assessed the performance of Islamic banks in some Middle Eastern countries and found it to be well beyond acceptable levels.

Samad (1999) compared the performance of one Malaysian Islamic bank to seven conventional banks over the period 1984-1997. The Islamic bank was found to perform better than conventional banks in terms of liquidity and risk measurement (less risky). Although this study is based only upon one Islamic bank in Malaysia, the study is significant because it gives the efficiency of an Islamic bank outside the Middle Eastern region. A similar study by Sarker (1999) used Bangladesh as a case study. He argued that Islamic products have different risk characteristics, yet Islamic banks can survive even within a conventional banking architecture. Overall, the general finding from this kind of studies is that Islamic banks

[17] For definition of these ratios, see Iqbal (2001), pp. 10-15.
[18] Reproduced from Iqbal 2001.

are at least as efficient as their conventional competitors and in most cases out-performed them.

In recent years, studies employing more rigorous statistical techniques have reached similar results[19]. Al-Shammari (2003) used the translog stochastic cost and alternative profit frontier approaches to estimate bank efficiency in GCC countries and compared Islamic bank efficiency with other types of banks. Cost efficiency estimates for banks in the countries under study averaged 88%. These estimates improved over time from 84% in 1995 to 91% in 1999. This suggests that the same level of output could be produced with approximately 88% of current inputs if banks under study were operating at the most efficient level[20]. He then repeated the aforementioned analysis and estimated alternative profit efficiency for the same sample. For different bank types the profit efficiency scores ranged from 64% for investment banks to 73% for the Islamic banks. He concluded that in the GCC countries, Islamic banks are the most cost and profit efficient while investment banks are the least efficient.

The finding that Islamic banks are most cost and profit efficient than conventional banks is a finding confirmed in a similar study by Al-Jarrah and Molyneux (2003). They also use the stochastic frontier approach, with the Fourier-flexible functional form, and estimate banks cost and profit efficiency estimates for banks operating in Bahrain, Jordan, Egypt and Saudi Arabia. The study showed that the average cost efficiency for commercial banks was 94%, for investment banks it was 93% whereas for Islamic banks, it was 98%. They also estimated both standard and alternative profit efficiency for their sample of banks and the results are around 66% and 58% respectively over the period 1992-2000. It should be noted that these levels of efficiency are similar to that found in US studies which is about half of the industry's potential profits, according to Berger and Humphrey (1997).

Abdul Majid *et al.* (2003) used the stochastic cost frontier approach to estimate the cost efficiency of Malaysian banks over the period 1993 to 2000. Their data set included 34 banks (24 local and 10 foreign) from a total of 55 commercial banks in operation during the period of study. They used translog cost function to arrive at inefficiency measures. Their results show that Islamic banks did marginally better than conventional banks in

[19] For a good discussion of these techniques along with some results, see Molyneux and Iqbal (2005), pp174-254.

[20] This level of technical inefficiency is similar to the range of 10-15% found in the survey of 130 studies undertaken by Berger and Humphrey (1997).

terms of efficiency although both produce at a cost that is respectively 30.2% and 28% higher than necessary. The slight edge achieved by the Islamic banks over conventional banks is not however statistically significant. However, it can be safely concluded that Islamic banks are at least as efficient as their conventional counterparts despite a more restrictive business environment. It is also interesting to note that foreign banks are generally more efficient than local banks. Further test suggests that the difference is statistically significant at the 5% level.

El-Gamal and Inanoglu (2002) used the stochastic cost frontier approach to estimate the cost efficiency of Turkish banks over the period 1990 to 2000. The study compared the cost efficiencies of 49 conventional banks with four Islamic special finance houses (SFHs). The Islamic firms comprised around 3% of the Turkish banking market. Overall, the authors found these firms to be the most efficient and this was explained by their emphasis on Islamic asset-based financing which led to lower non-performing loan ratios. It should also be noted that the SFHs achieved high levels of efficiency despite being subject to branching restrictions and other self-imposed constraints such as the inability to hold government bonds. El-Gamal and Inanoglu (2004) substantially extend their earlier study by providing an alternative method for evaluating bank efficiency scores. Again they examine the cost efficiency of Turkish banks throughout the 1990s. They distinguish between groups of banks that have different production technologies. They find that the Islamic financial firms have the same production technology as conventional (mainly domestic) banks, and using standard stochastic cost frontier estimates they show that the Islamic firms are among the most efficient. In addition, they use a new labour efficiency measure – and again Turkish Islamic special finance houses are found to be among the most efficient.

Yudistira (2004) used a linear programming technique, Data Envelopment Analysis (DEA) to examine the efficiency of Islamic banks using a sample of 18 of the most important Islamic banks. The overall efficiency results from the study suggested that the inefficiency across 18 banks is small at just over 10 percent, which is quite low compared to many studies that estimated similar statistics for conventional banks[21].

9. Conclusions

Islamic banking, like any other banking system, must be viewed as an evolving system. Serious research work of the past fifty years has

[21] See, for example Goddard et al (2001).

established that Islamic banking is a viable and efficient way of financial intermediation. Islamic scholars and practical bankers have developed a number of financial instruments which can be used by Islamic banks in performing various banking functions in a modern economy. Islamic banking practice which started in early 1970s on a modest scale has shown tremendous progress during the last 30 years. A number of Islamic banks and other Islamic financial institutions have been established under heterogeneous, social and economic milieu. Recently, many conventional banks, including some major multinational Western banks, have also started using Islamic banking techniques. Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving. To design various parameters of such a system and establish supporting institutions are the biggest challenges facing the scholars and practitioners of Islamic finance in the new millennium.

While Islamic banking fulfils the religious requirements for Muslims, it also broadens the choice-set available to others by offering both sales-finance, low-risk products (i.e. buying and selling) as well as products based on sharing risks and returns. In addition to providing more choices to clients, this mix of fixed and variable return modes has a number of healthy effects for the efficiency and stability of the system. Islamic banking should not be seen as a religious movement. It is simply another way of performing the financial intermediation function and experience has shown it to be an attractive one.

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Annexure

Some Islamic Financial Products[22]

I. *Musharaka* (Partnership)

Musharaka literally means sharing. In the Islamic finance literature, it refers to an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule. The profit of the enterprise is shared among the partners in agreed proportions while the loss has to be shared in strict proportion of capital contributions. The basic rules governing the *musharaka* contract include:

i) Profit of the enterprise can be distributed in any proportion by mutual consent. However, it is not permissible to fix a lump sum profit for anyone.

ii) In case of loss, it has to be shared strictly in proportion to the capital contributions.

iii) As a general rule, all partners contribute both capital and management. However, it is possible for any partner to be exempted from contributing labour/management. In that case, the share of profit of the sleeping partner has to be in strict proportion of his capital contribution.

iv) The liability of all the partners is unlimited.

As a mode of finance, an Islamic bank can advance money to a client using the contract of *musharaka*. Normally the bank will use the option of being a sleeping partner. The contract can be more widely used by Islamic funds whereby the unit holders can assume the role of sleeping partners. The contact can also be used in securitized assets.

II. *Mudaraba* (Passive Partnership)

Mudaraba is a special type of partnership. This is a contract between two parties[23]: a capital owner (called *rabb al-mal*) and an investment manager (called *mudarib*). Profit is distributed between the two parties in

[22] Revised and updated from Jarhi and Iqbal (2001).

[23] There could be more than two parties. The contract is explained using a two-party example only for simplicity.

accordance with the ratio that they agree upon at the time of the contract. Financial loss is borne by the capital owner; the loss to the manager being the opportunity cost of his own labour, which failed to generate any income. Except in the case of a violation of the agreement or default, the investment manager does not guarantee either the capital extended to him or any profit generation. Some other important features of the *mudaraba* contract include:

i) While the provider of capital can impose certain mutually agreed conditions on the manager, he has no right to interfere in the day-to-day work of the manager.

ii) *Mudaraba* is one of the fiduciary contracts (*uqud al-amanah*). *Mudarib* is expected to act with utmost honesty, otherwise he is considered to have committed a grave sin (in addition to worldly penalties). This has important implications for the moral hazard problem.

iii) The liability of the *rabb al-mal* is limited to the extent of his contribution to the capital.

iv) The *mudarib* is not allowed to commit the *mudaraba* business for any sum greater than the capital contributed by the *rabb al-mal*.

v) All normal expenses relate to *mudaraba* business, but not the personal expenses of the *mudarib,* can be charged to the *mudaraba* account[24].

vi) The contract of *mudaraba* can be terminated at any time by either of the two parties on giving a reasonable notice. This condition may create serious problems in the context of modern commercial enterprises. However, the parties can agree on any conditions in the contract that will regulate the termination so as not to cause any damage to the enterprise.

vii) No profit distribution can take place (except as an ad hoc arrangement, and subject to final settlement), unless all liabilities have been settled and the equity of the *rabb al-mal* restored.

As a mode of finance applied by Islamic banks, on the liabilities side, the depositors serve as *rabb-al-mal* and the bank as the *mudarib*. *Mudaraba* deposits can be either general, which enter into a common

[24] However, in case of travelling outside the place of business, the *mudarib* is entitled to travel and living expenses during the trip.

pool, or restricted to a certain project or line of business. On the assets side, the bank serves as the *rabb-al-mal* and the businessman as the *mudarib* (manager). However, the manager is often allowed to mix the *mudaraba* capital with his own funds. In this case, profit may be distributed in accordance with any ratio agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them.

III. Diminishing Partnership

This is a contract between a financier (the bank) and a beneficiary in which the two agree to enter into a partnership to own an asset, as described above, but on the condition that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule.

IV. *Bai´ al- Murabaha* (Sales Contract at a Profit Mark-up)

In the classical *fiqh* literature, there is a sales contract called *bai´ mu'ajjal* which refers to sale of goods or property against deferred payment (either in lump sum or instalments). *Bai´ mu'ajjal* needs not have any reference to the profit margin that the supplier may earn. Its essential element that distinguishes it from cash sales is that the payment is deferred. Strictly speaking, the deferred payment can be higher than, equal to or lower than the cash price.

There is another sale contract known as *bai´ al- murabaha*, which refers to a sale in which the seller declares his actual cost and the parties agree on adding a specific profit margin. Basically, this is a two party buying and selling contract. No financial intermediation is involved. The Islamic banks have created a mode of finance by combining the concepts of *bai´ mu'ajjal* and *bai´ al- murabaha.* They use this contract as a mode of finance in the following manner.

The client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such commodity from the bank once it has been bought, but at a deferred price, which includes an agreed upon profit margin called mark-up in favour of the bank. Thus, the transaction involves an order accompanied by a promise to purchase and two sale contracts. The first contract is concluded between the Islamic bank and the supplier of the commodity. The second is concluded between the bank and the client who placed the order, after the bank has possessed the commodity, but at a deferred price, that includes a mark-up. The deferred price may be paid as a lump sum or in

instalments. In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as its agent to receive the goods purchased by the bank.

The basic rules governing the *murabaha* contract include:

i) The subject of sale must exist at the time of sale.

ii) The subject of sale must be in the ownership of the seller at the time of sale.

iii) The subject of sale must be in the physical or constructive possession of the seller.

iv) The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

v) As in any sales contract, the price must be specified, and once specified, it cannot be increased in case of default.

vi) The time of delivery must be specified.

vii) The payments schedule must be specified.

V. *Ijarah* (Leasing)

In the simple lease contract the usufruct generated over time by an asset, such as machinery, airplanes, ships or trains is sold to the lessee at a predetermined price. This is called an operating lease, as opposed to a financial lease. The operating lease has a number of features that distinguish it from other forms of leasing. Firstly, the lessor is himself the real owner of the leased asset and, therefore, bears all the risks and responsibilities of ownership. All defects, which prevent the use of the equipment by the lessee, are his responsibility, even though it is possible to make the lessee responsible for the day-to-day maintenance and normal repairs of the leased asset. Secondly, the lease is not for the entire useful life of the leased asset but rather for a specified short-term period (for a month, a quarter, or a year) unless renewed by mutual consent of both the parties.

VI. A Lease Ending in the Purchase of the Leased Asset

Since the entire risk is borne by the lessor in the operating lease, there is a danger of misuse of the leased asset by the lessee. The financial lease helps take care of this problem by making the lease period long enough (usually the entire useful life of the leased asset), to enable the lessor to amortize the cost of the asset with profit. At the end of the lease period the lessee has the option to purchase the asset from the lessor at its market

value at that time. The lease is not cancellable before the expiry of the lease period without the consent of both the parties. There is, therefore, little danger of misuse of the asset.

A financial lease has other advantages too. The leased asset serves as security and in case of default on the part of the lessee the lessor can take possession of the equipment without court order. It also helps reduce the lessor's tax liability due to the high depreciation allowances generally allowed by tax laws in many countries. The lessor can also sell the equipment during the lease period such that the lease payments accrue to the new buyer[25]. This enables the lessor to get cash when he needs liquidity. This is not possible in the case of a debt because, while the *sharī´ah* allows the sale of physical assets, it does not allow the sale of monetary debts except at their nominal value.

Some of the jurists have expressed doubts about the permissibility of financial leases. The rationale they give is that the long-term and non-cancellable nature of the lease contract shifts the entire risk to the lessee, particularly if the 'residual' value of the asset is also fixed in advance. The end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan. However, there are jurists who consider financial leases to be permissible if certain conditions are satisfied. Firstly, the lessor must bear the risks of leasing by being the real owner of the leased asset. The lessor cannot lease what he does not own and possess, and should be responsible for all the risks and responsibilities related to ownership. Therefore, a leasing contract where the lessor acts only as an intermediary between the supplier and the lessee and plays the role of only a financier, with ownership of the asset being nothing more than a legal device to provide security for repayment of the loan and legal protection in case of default, is not allowed. In this case the lessor leases an asset before buying and taking possession and gets a reward without bearing any risk. Secondly, lease payments cannot start until the lessee has actually received possession of the leased asset and can continue only as long as it remains usable by him. Thirdly, all manufacturing defects and later damages which are beyond the control of the lessee, should be the lessor's responsibility[26]. The lessee can, however, be made responsible for the proper upkeep and maintenance of the leased asset.

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[25] The new buyer has to agree to continue the lease on the conditions previously agreed unless the lessee willingly agrees to new conditions.

[26] Some of these can be insured against, but this has to be done by the lessor at his own cost.

VII. *Salam*

Salam is a sales contract in which the price is paid in advance at the time of contracting, against delivery of the purchased goods/services at a specified future date. Not every commodity is suitable for a *salam* contract. It is usually applied only to fungible commodities. Some basic rules governing the *salam* sale are given below:

i) The price should be paid in full at the time of the contract.

ii) Goods whose quality or quantity cannot be determined by specification cannot be sold through the contract of *salam*. An example is precious stones.

iii) Goods can be sold only by specifying the attributes. They cannot be particularized to a given farm, factory or area.

iv) The exact date and place of delivery must also be specified.

Islamic banks can provide financing by way of a *salam* contract by entering into two separate *salam* contracts, or one *salam* contract and an instalments sale contract. For example, the bank could buy a commodity by making an advance payment to the supplier and fixing the date of delivery as the date desired by its client. It can then sell the commodity to a third party either on a *salam* or instalments sale basis. If the two were *salam* contracts, the second contract would be for delivery of the same quantity, description, etc., as that constituting the subject-matter of the first *salam* contract. This second contract is often concluded after the first contract, as its price has to be paid immediately upon conclusion of the contract. To be valid from the *sharī´ah* point of view, the second contract must be independent, i.e., not linked to the delivery in the first contract. Should the second contract consist of an instalments sale, its date should be subsequent to the date on which the bank would receive the commodity.

VIII. *Al-Istisna* (Contract of Manufacture) and *Al-Istisna Al-Tamwili* (Financing by Way of *Istisna*)

Istisna is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract. Any party can cancel the contract after giving a notice to the other before the manufacturing work starts. However, after the manufacturing work has started, the contract cannot be cancelled unilaterally.

Istisna is similar to *salam* in the sense that both are exceptions to some general conditions of sale which prohibit selling of something which is not owned and is not in the possession of the seller at the time of sale. However, there are some differences between the two which are summarized below:

i) The subject of *istisna* is always a thing which needs manufacturing, while *salam* can also be effected on things that do not involve manufacturing.

ii) In the case of *salam* full payment of price is necessary whereas in case of *istisna* the payment can be delayed.

iii) The time of delivery in case of *salam* must be specified at the time of the contract. In the case of *istisna* this is not necessary.

Istisna Al-Tamwili, which is used by Islamic banks, consists of two separate *istisna* contracts. The first is concluded between the beneficiary and the bank, in which the price is payable by the purchaser in future, in agreed instalments and the bank undertakes to deliver the requested manufactured commodity at an agreed time. The second *istisna* contract is a subcontract concluded between the bank and a contractor to manufacture the product according to prescribed specifications. The bank would normally pay the price in advance or during the manufacturing process in instalments. The latter undertakes to deliver the product to the bank on the date prescribed in the contract, which is the same date as that stated in the first *istisna* contract. The original purchaser (i.e., the bank's client) may be authorized to receive the manufactured commodity directly from the manufacturer.

IX. *Jualah*

It is a contract to perform a given task against a prescribed fee (in a given period). The services of real estate agents are a good example. For example, someone places his house for sale with a real estate agent, say within three months. If the real estate agent is able to sell it, he gets an agreed compensation (usually a percentage of the sale price). If he fails to sell it, he gets nothing and loses his effort and publicity costs. Banks can use this contract for providing some services against a fixed fee.

X. *Wakalah*

Wakalah is a contract whereby somebody (principal) hires someone else to act on his behalf i.e. as his agent for a specific task. The agent is entitled to receive a predetermined fee irrespective of whether he is able to accomplish the assigned task to the satisfaction of the principal or not as

long as he acts in a trustworthy manner. He would be liable to penalties only if it can be proved that he violated the terms of the trust or acted dishonestly.

In the case of a financial *wakalah* contract, clients give funds to the bank/company that serves as their investment manager. The bank/company charges a predetermined fee for its managerial services. Entire profit or loss is passed back to the fund providers after deducting such a fee.

This contract is used by some Islamic banks to manage funds on an off-balance sheet basis. The contract is more widely used by Islamic mutual funds and finance companies.

XI. *Takaful*

Takaful is an alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.

A Takaful company has the following features:

i) The company is not the one who assumes risks nor the one taking any profit. Rather, it is the participants, the policy holders, who mutually cover each other.

ii) All contributions (premiums) are accumulated into a fund. This fund is invested using Islamic modes of investment and the net profit resulting from these investments is credited back to the fund.

iii) All claims are paid from this fund. The policy holders, as a group, are the owners of any net profit that remains after paying all the claims. They are also collectively responsible if the claims exceed the balance in the fund.

iv) The company acts as a Trustee on behalf of the participants to manage the operations of the *Takaful* business. The relationship between the company and the policy holders is governed by the terms of *mudaraba* contract. Therefore, should there be a surplus from the operation; the company (*mudarib*) will share the surplus with the participants (*rabb-al-mal*) according to a pre-agreed profit-sharing ratio.

XII. *Sukūk*

Sukūk are instruments for pooled securitizations. These are secondary instruments based on returns from real assets or their usufruct. *Sukūk* are meant to mobilize resources from the market based on the strength of one's balance sheet, credentials, track record, good will and prospects of the proposed project. These are basically, certificates of ownership which may or may not be negotiable in secondary markets. In recent years, Islamic financial engineers have developed a number of such instruments. These include, *ijarah ṣukūk*, *muqarradah bond/ṣukūk*, *mudaraba ṣukūk*, *salam ṣukūk* etc.

Islamic scholars offer the following general guidelines for issuing of securitized Islamic financial instruments:

i) Instruments should represent share in equity, real assets, usufruct, money or debt or a combination of some or all of these;

a) instruments representing real physical assets and usufructs are negotiable at market price,
b) instruments representing money are subject to the rules of *sarf* (money exchange) in their negotiability,
c) instruments representing a combination of different categories are subject to the rules relating to the dominant category.

ii) The issuance of securitized Islamic financial instruments based on *mudaraba* or *musharaka* is subject to the following conditions:

a) the principal and expected return on investment cannot be guaranteed
b) if the financial instruments were issued for specific purposes or projects, the prospectus should include full disclosure of the nature of the activities, contractual relationships and obligations between the parties involved and the ratio of profit sharing,
c) the issuers of financial instruments should keep separate accounts for each project and must declare its profit and loss accounts at the date mentioned in the prospectus and balance sheets.

iii) Holders of Islamic financial instruments are the owners of whatever rights these instruments represent and bearers of all related risks, and

iv) An instrument the object of which is debt should not be allowed to earn any return and that its negotiability must be in accordance with the *sharī´ah* rules.