

Fundamentals of
ISLAMIC FINANCE
(Text Book)

5th Edition

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[Academic members may contact for solution manual]

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This book is written by an accountant;
NOT a *Mufti* (Jurist in Islamic Law); for general
understanding in the area of Islamic finance and Must not be assumed Fatwa
(Juristic opinion) on the Subject. The reader is requested to consult the original Sources;
or a *Mufti* for Determination of *Haram & Halal* (prohibited & permitted) in a particular situation.

To

Inquisitive minds; in search of truth, knowledge and justice

PREFACE

This book is the result of a decade teaching of Islamic finance course to business graduates (Bachelor and Master classes). This book is written with a clear focus on learning of Islamic banking & finance by accounting, banking, business and finance students/professionals. Resources available, so far, on the subject have focused on the legal side, and very negligible work is available on the financial front for a common user. This book is written in financial perspective, and the author has focused upon financial impacts, generated by the application of Islamic financial laws. However, a summary of Islamic commercial laws in each chapter has been provided.

This book is divided into five parts. Part-1 presents an update on Islamic finance, why and how Islamic banking started; What is current status; Meaning and prohibition of Riba (Interest & Usury) as reported in revealed books (Bible and Qur'an); business models under Islamic financial services industry; principles of Islamic financial system, similarities and differences with conventional finance industry, and challenges being faced by the nascent industry.

Part two is about asset-backed financing provided by IFIs. It includes trading (selling) modes of financing including *Murabaha*, *Salam*, and *Istisna'a*; it also includes rental-based financing product—*Ijarah* financing. At the start of part two, a summary of *Shari'ah* rulings about sales is reported. Chapter two is about the *Murabaha* (cost plus profit) the most widely used financing tool by Islamic Financial Institutions (IFIs) world over and *Bai-Muajjal* (deferred sale). *Murabaha* is a useful tool to replace overdraft and short-term interest-based financing. The chapter discusses the basic rules of *Murabaha*, necessary steps involved and comparative study with conventional short-term loans including bank overdraft facility. Chapter three is about *Bai-Salam*; a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery. It is a recommended contract in the financing of agricultural needs of farmers. Chapter four is about *Istisna'a* financing. This mode of financing is designed to transact business through an order to manufacture and/or supply. It is a sales contract except the existence of subject matter. This tool of

financing is useful for infrastructure projects. Chapter five is about *Ijarah*; a rental contract whereby IFIs lease an asset for a specific rent and period to the client. *Ijarah* is useful in replacement of conventional lease financing.

Part three of the book deals with profit and loss sharing modes of financing including *Musharakah*, diminishing *Musharakah* and *Mudarabah*. A special section is devoted to discussing the causes of lesser application of *Musharakah* in operations of IFIs, in addition to *Shari'ah* rulings and financial impact. Chapter seven is about Diminishing *Musharakah*; a form of gradually declining partnership between an IFI and clients; generally used to finance real estates. Under diminishing *Musharakah*, the basic *Shari'ah* rulings, Islamic house financing, comparative study of conventional and Islamic mortgages and installment calculation under different assumptions for house financing are presented. Chapter eight is about *Mudarabah*. Under this scheme of financing, IFIs are expected to provide capital to financially weak but skillful people to do the business and share the outcome with IFIs. Part three concludes with a chapter on deposits management. Chapter nine presents various types of deposits collected by IFIs and profit-sharing mechanism. Concepts of daily product and weight-age based profit systems are elaborated.

Part four of the book presents special topics in Islamic Finance. In this part areas of liquidity management, Islamic insurance, currency system, substance & form, and challenges to Islamic finance industry are elaborated. Under Islamic capital market (liquidity management) two dedicated chapters have been included; each for equities and *sukuk*. *Shari'ah* compliance of equity securities, evaluation of *Shari'ah* universe of stocks' methodology, trading rules, and valuation mechanism discussed under equity chapter. Chapter-11 on *sukuk* includes origin, development, types and *sukuk* process along with *Shari'ah* rulings. Chapter 12 elaborates briefly the concept of Islamic insurance covering multiple areas including *Shari'ah* guidelines, *takaful* (insurance) models, and role of insurance company, in addition to illustrative financial calculations. Chapter-13 addresses the issue of preference for 'legal form over economic substance' by critically evaluating the selected Islamic finance contracts including *Murabaha*, *Ijarah*, mortgages, *Mudarabah* deposits and *sukuk*. Last chapter identifies the challenges [potentially hurdles in sustainability, growth and expansion of the industry].

The fifth edition is the outcome of very encouraging response by the academic community to earlier editions. In this edition, due attention has been given to present material in a reader-friendly mode in addition to a thorough review of content, exercises and figures. Title of the book changed by adding prefix of 'fundamentals' to reflect the nature of work (as text book). In this edition, the chapter on Islamic finance: an update is revised thoroughly; and by insertion of specific contents including principles and business models of Islamic financial system, in addition to brief presentation of challenges. Besides, Islamic capital market is re-written by including an evaluation of methodologies used in creation of *Shari'ah* universes of stocks. Also, a new chapter included to present the application of 'form over substance' principle to industry practices. Updated figures on the global volume of assets, application of financial products; regional shares, etc. are also part of this edition. Also, more examples included in the text to make the concept clear. Financial reporting calculations deleted, discussed elsewhere in accounting books. An increased number of multiple-choice questions and mini cases are also forming part of the updated edition.

This book is useful for MBA/BBA students as a three-credit hour course as well as for banking/finance students and practitioners of Islamic banking & finance. It is also useful for accounting & finance professionals, trainers in Islamic banking, regulators, investors, corporate managers and the general public, interested in understanding Islamic financial system. I hope this book will serve its purpose through imparting knowledge of Islamic banking & finance among accounting, business and finance graduates as well as practitioners of Islamic financial system, investors, and the general public.

I am thankful to Allah SWT (God) for granting me health, courage, wisdom and knowledge to complete this task. I am also thankful to everyone who assisted me at any stage of my life including my parents, teachers, and family. My wife and kids deserve special thanks for their patience during completion of this book.

Muhammad Hanif

August 2020

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ACRONYMS

AAOIFI:	Accounting & Auditing Organization of Islamic Financial Institutions
AED:	United Arab Emirates <i>Dirham</i>
AIML:	Al-Meezan Investment Management Limited
BPs:	Basis Points
DIFC:	Dubai International Financial Centre
DM:	Diminishing <i>Musharakah</i>
FAS:	Financial Accounting Standard
GIFR:	Global Islamic Finance Report
IBI:	Islamic Banking Institution
IDB:	Islamic Development Bank
IFA:	Islamic <i>Fiqh</i> Academy
IFI:	Islamic Financial Institution
IFSB:	Islamic Financial Services Board
IIFM:	International Islamic Financial Market
OIC:	Organization of Islamic Conference
PKR:	Pakistani Rupee
PLS:	Profit & Loss Sharing
SBP:	State Bank of Pakistan
SS:	<i>Shari'ah</i> Standard
TMCL:	Time Multiple Counter Loan
NRR:	Normal Rate of Return
IBLI:	Inflation Based Loan Indexation
PTC:	Participation Term Certificate
TFC:	Term Finance Certificate

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Part-1

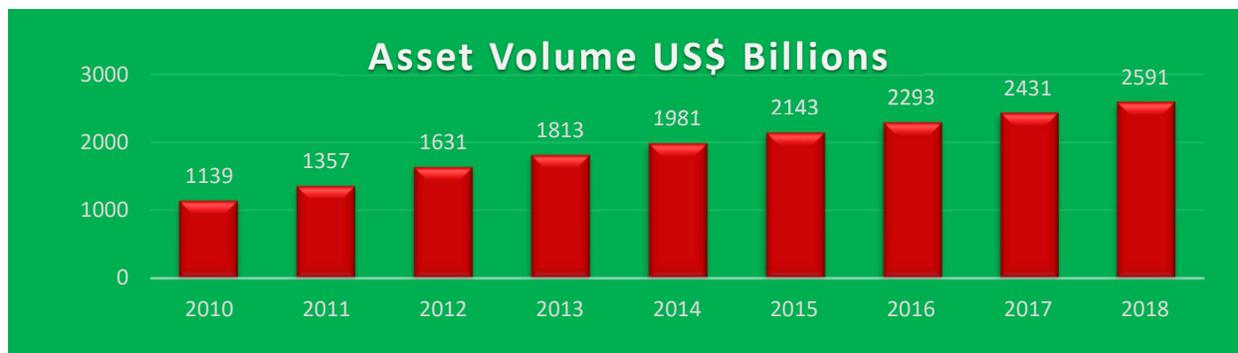
ISLAMIC FINANCE

Development of Islamic financial services industry is a reaction to specific questionable practices (from religious perspectives) under existing capitalistic financial system. The practices include dealing in *riba* (interest & usury), *gharar* (uncertainty in price or delivery of object), *maisir* & *qimar* (speculation, gambling), and absence of ethical filtration. From economic perspective, objectives of Islamic financial system include financial stability and equitable distribution of wealth.

The introductory chapter on Islamic financial system addresses multiple aspects of modern Islamic finance industry. The chapter starts with the question as why Islamic financial system is needed, then documents the historic developments contributed to the present shape of the industry. A section is devoted to introduce very briefly the religion of Islam. After reporting the current state of the Islamic finance industry an account of *riba* (interest & usury) in light of revealed injunctions is presented. Elimination of *riba* from financial system is one of the major motivating factors in development of modern Islamic finance industry. A brief introduction to Islamic finance business models including asset-based financing, profit & loss sharing, capital market operations, Islamic insurance and socioeconomic services is presented; and salient features of Islamic financial system are then presented. In the next sections, Islamic finance principles as well as differences and similarities with conventional finance are reported. Finally, multiple challenges [potentially hinder the sustainability of the industry] to modern Islamic financial system are highlighted. At the end of the chapter, essay questions and multiple-choice questions are included to develop understanding of readers.

Chapter 1

ISLAMIC FINANCE: AN UPDATE



Growth in Assets under Islamic Finance [globally] in last eight years [2010-18]; Data Source: Global Islamic Finance Report (GIFR-2019)

Islamic Finance is a faith-based financial system regulated by Islamic commercial laws. Interest (the foundation of modern conventional banking) is prohibited by Islamic law; hence, operations of Islamic banking are different from conventional banking, although both types of banking fulfil the similar needs of customers. In financing customers' needs, Islamic banks use either trading or profit and loss sharing modes of financing. Islamic banking was started in the last quarter of the 20th century to cater the needs of Muslims around the world, although it is not limited to Muslims only. It has shown tremendous growth and expansion worldwide. The global volume of assets under the Islamic financial system has reached the figure of US\$ 2.5 trillion by the end of 2018 (potential size is above US\$ 9.0 trillion), depicting average yearly growth above 15% from 2010-18 [GIFR-2019]. The Arabian Gulf region is the centre of Islamic Finance with a significant share in global Islamic financial assets.

Learning objectives

After going through this chapter, the reader is expected to understand and interpret the following:

Why had Islamic finance?

How is it developed?

What is the present status of Islamic finance?

What have revealed injunctions about the *ribā*?

What are business models under Islamic financial system?

What are the salient features of Islamic Finance?

What are the differences in conventional and Islamic Finance?

What are the criticisms and challenges for Islamic banking?

1.1. INTRODUCTION

Why Islamic Finance?

Specific ideologies build societies, and the formation of Muslim community is based on Islamic ideology. To understand the institution-building in a community, understanding of the thinking, worldview and philosophy of life (and death) is a prerequisite. There are three principles (*Asool-e-Din*) of the Islamic religion as following. First is *Tauwheed*, Muslims believe in the oneness of *Allah* (God) the sole creator of this universe. Second is *Risalah*, the belief in prophet-hood (Messengers of Allah came to the world to reform the society). The third is *Akhirah*, the establishment of the Day of Judgment (everyone has to be answerable for his deeds before *Allah*). Muslims believe that *Qur'an* is the final revealed book of *Allah*. According to the religion of Islam, the life of every believer is regulated through the revelations (*Qur'an & Sunnah*). To extract legal order from *Qur'an & Sunnah*, religious scholars conduct research and come up with a solution to an existing problem keeping in view the objectives of Shari'ah (Islamic law). Objectives of Shari'ah include protection of faith (*Hifz e Eimaan*), the protection of life (*Hifz e Nafs*), the protection of wealth (*Hifz e Maal*), the protection of intellect (*Hifz e Aqal*) and protection of lineage (*Hifz e Nasal*) [Siddiqi, 2000]. It is settled opinion of Muslim jurists that any sphere of life of believers either directly regulated through revelations or juristic opinion (in light of and in agreement with *Shari'ah* percepts) by experts in *Shari'ah*—if the direct order is not available in *Qur'an & Sunnah*. Hence, financial matters have no exception. Economies and personal financial dealings of Muslims are to be regulated by *Shari'ah*.

Capitalism is the dominant economic system prevailing (complete or partial) in almost every society of the world, including Muslim countries. According to capitalism, factors of production include land, labour, capital and organization. Rewards for three of the production-factors (i.e. land, labour, and capital) are fixed while the remuneration of an entrepreneur is variable depending upon the outcome of the underlying project. The reward for three factors of production is risk-free and cannot be negative; however, the entrepreneur's reward can be zero or even negative. Although the underlying project is completed by the participation of all the factors of production; however, in the case of reward, the share of three of them (land, labor and capital) is fixed; irrespective of the outcome. If a vast profit is earned, it belongs to entrepreneur (after servicing other factors of production) and if a substantial loss is suffered that is also borne by the entrepreneur.

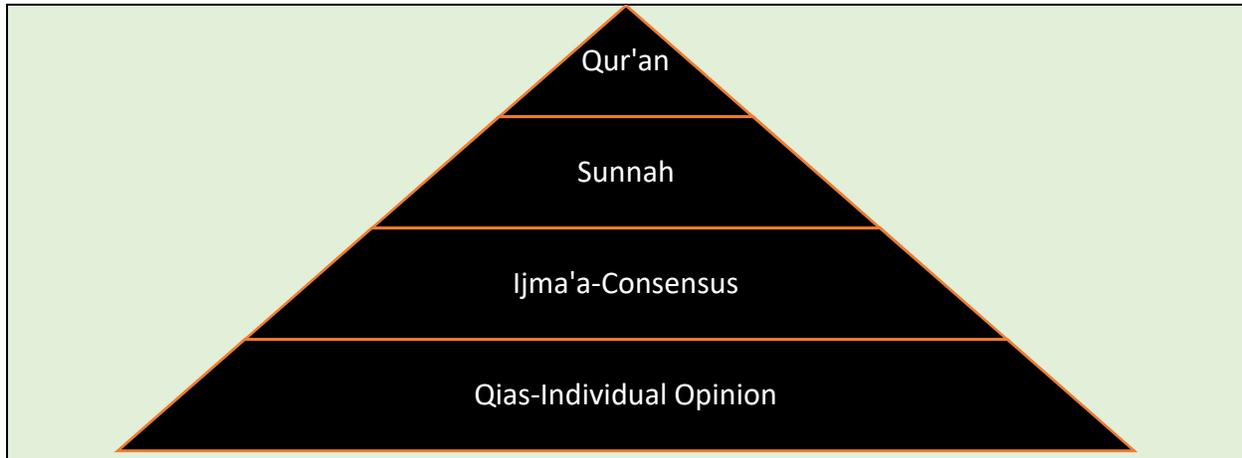
According to *Shari'ah* [Islamic Law] reward for an entrepreneur is not fixed; hence, it is a similarity in capitalism and Islamic financial system. However, the difference lies in the fixation of compensation for capital. According to the Islamic financial system, the reward for money is also variable and not predetermined. For Muslims, the practice of pure capitalism in its original form does not suit well because it contradicts with faith. An ordinary Muslim is very much confused about his economic matters; because the business world is dominated by capitalism especially interest-based banking. On one side is the cherished dream of development and an improved standard life while on the other hand, is faith in Allah, which demands abide by the *Shari'ah*.

Sources of law in Islam have categorized/ranked (into four) keeping in view the changing needs of the society. Two are the prime sources (*Qur'an* & *Sunnah*) while two are derivations/inferences, i.e. *Ijma'a* (consensus opinion of clerics) and *Qiyas* (individual viewpoint of a scholar) [Figure-1]. *Qur'an* (the revealed book of Islam) is at the top in order, and if guidance in a matter is not discussed in *Qur'an* then *Sunnah* (includes actions, sayings & approvals of Prophet *Muhammad* PBUH) is consulted. If no advice found in *Sunnah* relating to the underlying matter, then *Ijma'a* (consensus/majority opinion of experts in *Shari'ah*) is consulted. Finally, if nothing exists in *Ijma'a* relating to the underlying issue, then *Qiyas* (individual opinion of an expert in *Shari'ah*) is allowed.

Why Islamic Finance?

1. About 60% of global population is people of book [Followers of Abrahmic Religions] including Jews, Christians and Muslims and dealing in *riba* (interest & usury) is Haram for them
 - a. Muslim population around the Globe is 1,977 Millions accessed on May 31, 2012 [<http://muslimpopulation.com/World/>]
 - b. Christian Population around the globe is 1,955 Millions accessed on May 31, 2012 [<http://www.religiouspopulation.com/World/>]
 - c. Jewish population around the World is 13.3 Millions, accessed on May 31, 2012 [<http://www.simpletoremember.com/vitals/world-jewish-population.htm>]
2. Conventional finance led to financial crisis due to lack of support from real assets
3. Islamic finance is asset based financing, hence can serve as hurdle in the way of financial crisis
4. Islamic finance promotes equity based financing which discourage the passive behavior of Investors/depositors. Islamic finance is based on principles of Profit and loss sharing, hence risk and reward is shared by capital providers, leading to active participation in managing and monitoring of underlying project.
5. Avoidance of Gharar (uncertainty); Absolute risk of outcome [Ayub, 2007; Mansoori, 2007 & Ghazi, 2010] ; Avoidance of Myser and Qimar (Game of chance) [Holy Qura'n 2:219 & 5: 90]
6. Promotion of only Halal (Permitted) Business [A landmark book on Halal & Haram by Qaradhawi 1960].
7. Islamic finance is expected to contribute in socio-economic justice and equitable distribution of wealth.

Figure-1. Ranking of Legal Sources in Islamic Doctrine



Source: Author's Work

Room for the difference in opinion for an individual exists in two sources of law, i.e. *Sunnah* and *Qiyas*. In the case of *Sunnah*, reporting authority of a *Hadith* (tradition) may be questioned; and *Ulema* (clerics) of Islam have done an outstanding job by categorizing *Hadiths* as weak and strong on the basis of reporting evidence. However, in the case of *Qiyas*, one can have a difference of opinion based on solid arguments not violating any principle of *Shari'ah* and precisely matching with the objectives of *Shari'ah*.

Prohibition of *riba* (usury and interest) has proven in three sources of law (*Qur'an*, *Hadith*, and *Ijma'a*), repeatedly; hence, no question of having a difference of opinion as far prohibition of *riba* is concerned, according to *Shari'ah* [detailed discussion in the next section].

- First, in *Qur'an*, four sets of verses have been identified dealing with the charging of *riba* (30:39, 4:161, 3:130, & 2:275-281) [Reported in the order of revelation. First *Surah* (chapter) number then *Aya* (verse) number];
- Second, several *Hadiths* clearing the meanings of *riba* in various transactions have been reported (Khan, 1989);
- Third, resolutions of the council of Islamic Fiqh Academy (IFA), Jeddah, and multiple juristic opinions, published elsewhere, are the expression of consensus and very much qualify the status of *Ijma'a* on the issue of *riba*; and
- Fourth, there are several scholars, who declared both usury and commercial interest Haram (Unlawful) (e.g. see Usmani 1999, 2002 & Usmani 2003, Qaradhawi 1960, Maudoodi 1961, Siddiqi 2006, Chapra n.d., Zaman 2010, Ayub 2007).

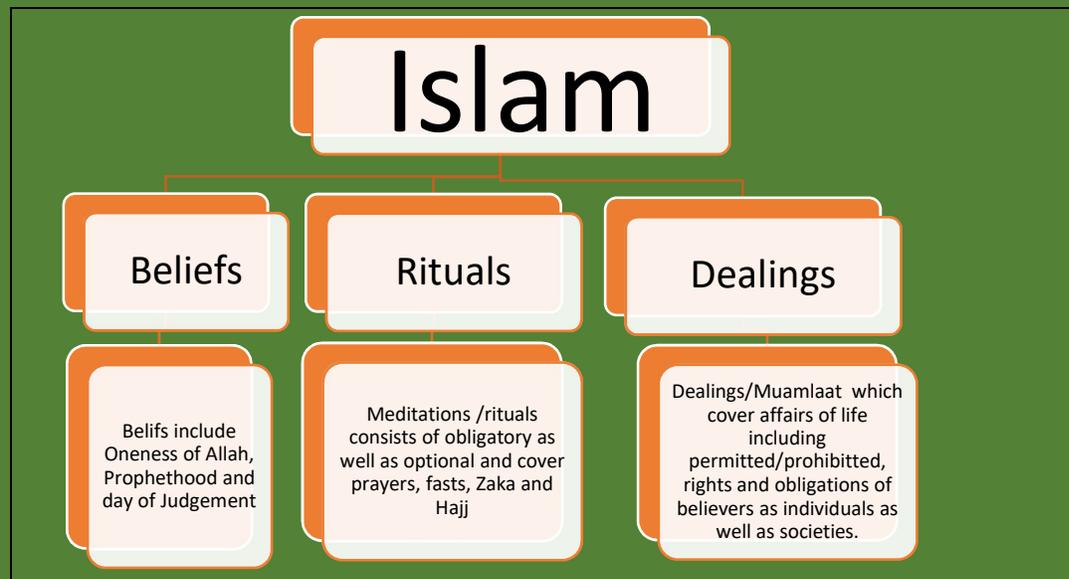
As discussed earlier, one may have a difference of opinion in two sources of law (*Sunnah* and *Qiyas*). However, not in *Qur'an* and *Ijma'a*; hence, it is very much clear now that *riba* [usury & commercial interest] is *Haram* (prohibited) undoubtedly because we found the evidence in *Qur'an*, *Sunnah*, and *Ijma'a*. However, there exists an opinion that commercial-interest is not included in the definition of *riba*, I have presented a detailed account in the second section of this chapter.

Interest (*riba*) is the foundation on which the organization of modern commercial as well as central banking is running and prospering. The vital role of these institutions in running the modern

economies cannot be undermined. Keeping in view the prohibition of interest and importance of banking in the marketplace, Muslims (scholars & professionals) decided to search for an alternative. After due consideration, they came up with the idea of Islamic banking. Islamic banking is not dealing in money like conventional banking. It is dealing in goods and services. Islamic finance (led by religion) is a reaction to certain questionable practices in the conventional financial system including *riba* [interest & usury], *gharar* [excessive risk], *maisir and Qimar* [speculation and game of chance]. Furthermore, Islamic finance is expected to refrain itself from financing the Haram [prohibited] segments of the business; and to promote social values including social justice and equitable distribution of wealth. Any business segment exists to serve the customers. There is no business without customer-base. Islamic finance is based upon values enshrined by Abrahamic religions—Judaism, Christianity and Islam. Close to 60% of the global population is follower of Abrahamic faiths. Islamic financial system aspires to serve this large clientele.

Islamic and conventional financial system are different in their philosophy as well as operations. Islamic banks are not dealers of money; hence, no provision of financing in hard currency is available while conventional banks provide hard cash as loans by charging interest. Likewise, Islamic banks cannot promise of a risk-free return to depositors while traditional banks are providing predetermined return (risk-free) to depositors. Islamic banks are traders of goods and services and not the loan houses as far financing is concerned, as per design, while conventional banks are lenders of cash. This difference is being reflected at the operational level as well (e.g. Islamic banks do not issue interest-based credit cards while conventional banks do). Islamic banks use financing tools being used in the trade including *Murabaha* (cost plus profit), *Ijarah* (rental arrangement), *Bai-Salam* (spot payment with delayed delivery of goods), *Bai-Muajjal* (deferred sale), *Istisna'a* (order to manufacture/supply) and Diminishing *Musharakah* (for house financing). On the other hand, if funding is required in cash form, then Islamic banks use profit and loss sharing modes, including *Musharakah* (partnership in the capital) and *Mudarabah* (partnership in money and skill).

The religion of Islam is the last message of a chain of prophets appeared in The Abrahamic generations and known as the final message of God (Allah) to humanity. Prophet *Muhammad* (PBUH) was born in the city of *Makkah* in the year 571 A.C. We can divide the religion of Islam objectively into three sections including Beliefs (*Aqayed*), Meditations/rituals (*Ibadaat*) and dealings (*Muamalaat*).



Beliefs

To start with beliefs, Islam teaches its followers to have faith in unity (oneness) of *Allah*; that God is one. To become a Muslim one has to state *Shahadah*—that there is no God except *Allah* (God). Who is the God of Muslims? God of Muslims (*Allah*) is the same God which is God of Jews and Christians. The God, which remained the Deity of Humanity starting from Prophet *Adam* to Prophet *Muhammad* (PBUH). At present, three nations are known as people of the book, including Jews, Christians, and Muslims. These three religions are known as Abrahamic religions, and their God is only One (*Allah*). So this is a commonality among these three nations that they believe in the same God.

A second belief which Islam teaches to its followers is the concept of Prophethood. It is stated that above 100,000 Prophets came to the world to reform the societies at different points in time in various regions of the world since the beginning, and a Muslim is required to believe in Their [Prophets'] truthfulness. It means Muslims are required by their religion to accept Moses (Prophet of Jews) and Jesus (Prophet of Christians) as the true Prophets [PBUH] of God. So this is the second similarity in these three Abrahamic nations.

The third is the concept of the day of judgment. A day when all the human being has to face the course of justice, and everyone has to be accountable for his/r actions before The Lord. On that day, people with good deeds will be rewarded by paradise and people with evil deeds will go to hell. This belief is also a commonality among Abrahamic nations.

However there is a difference between Muslims and others, and that is, others do not accept the *Muhammad* as Prophet of God; while Muslims believe in the finality of Prophethood and recognize *Muhammad* as the last Prophet [PBUH] of God, and *Qur'an* as the final book of God.

Meditations/Rituals

Meditations/Rituals can be categorized as obligatory and optional. Five times prayer [*Salah*] including early morning, afternoon, pre-dusk, post-dusk and pre-midnight/pre-sleeping [*Fajjar, Dohar, Asar, Maghrib, and Isha'a*] is obligatory. However, one can continue as much s/he likes to perform prayers [*Nafil*], and God promises reward.

The second form of meditation/ritual is Fasting [*Soam*]. One month [of *Ramadhan* as per lunar calendar] Fasting for a full day from dawn to dusk is obligatory for Muslims. Other Abrahamic nations do fast; however, the differences lie between fasting of Muslims and others, including timings of eating, and what to avoid during fast. Muslims can eat twice in a day [pre-dawn and post dusk]. Also, Muslims are not allowed to eat

or drink anything during the day while they are fasting. One can increase the number of fasts [*Nafl*] during the lifetime and reward is promised by God.

The third type of meditation/ritual is the payment of *Zakah*, i.e. 2.5% of total wealth annually should be given away as charity—subject to minimum wealth-limit. 2.5% of wealth spending on charity is obligatory, and one can increase the amount of expenditure on charity [*Nafl*], and reward is promised by the Lord.

Fourth type of meditation/ritual is *Hajj* [visit of *Makkah* during specific days]. Once in life, it is compulsory—subject to qualifications, including health and wealth. However, one can increase the number of visits as much, as he likes [*Nafl*] and expect a reward from the Lord.

Two of the meditations/rituals [*Ibadaat*] *Hajj* & *Zakah* are obligatory on affluent sections of the society. *Hajj* & *Zakah* are required on those individuals who can afford financially while prayer and fasts are for all with certain concessions in extreme cases.

Dealings

Dealings is the translation of Arabic word *Muamalaat* which includes lawful and prohibited, rights and obligations of a believer. In the case of legal and prohibited, Islam has guided about banned, and rest is legitimate [Qaradhawi 1960]. Islam covers the whole life of a believer; hence, a believer has to seek guidance from religion in every aspect of life. The feature of Islam to provide a list of prohibited and declaring the rest as lawful has made the religion of Islam an efficient system of life even after passing above 1,400 years. Life is moving ahead, and many new things are emerging. For a believer, every new thing is easy to adopt unless it falls in the prohibited list.

On this principle of prohibited and lawful, Muslims have adopted the modern financial system with certain modifications. There are certain practices in the contemporary economic system which are contradicting with the principles of Islamic code of life, including the following:

1. Interest [*riba*] is prohibited in Islamic law. There are four sets of verses in Holy *Qur'an* about *riba* [interest & usury]. Also, there are many traditions [*Ahadith*] reported in the books of traditions.
2. *Gharar* [absolute risk] in business/commercial transactions is prohibited. Hence, transactions with higher uncertainty such as of existing modern insurance, futures and forwards are against the Islamic law.
3. *Myser & Qimar* [game of chance (winning/losing)] is also prohibited in Islamic law.
4. Prohibited businesses [e.g. businesses include liquor, pork, pornography, promotion of adultery, etc.]

To address these issues, Muslims came up with the idea to reform the existing financial system in the light of Islamic teachings; hence modern Islamic financial system emerged. Islamic financial system is based on the objectives of *Shari'ah*, which is equally beneficial for Muslims & non-Muslims. Anybody who finds it appropriate financial solution can adopt Islamic finance. Islamic economic system addresses many commonalities among Abrahamic nations and also carries certain checks to avoid [or, at least, reduce the speed towards] a financial crisis, primarily due to asset-based financing. Islamic finance links the financial sector with the real industry; hence very encouraging news is emerging about the Islamic financial system¹.

Use of profit and loss sharing tools as financing modes changes the philosophy of doing the business of banking. Under the conventional financial system, the financier is earning a risk-free return in the form of interest while under Islamic financial system opportunity of risk-free return does not exist, consequently, increases the risk exposure of depositors as well as Islamic Financial Institutions (IFIs). Doing business according to principles of profit and loss sharing is difficult given the dominance of interest-based banking and non-conduciveness of the existing business environment. Under profit and loss sharing system result of the underlying project is shared by IFIs, depicted through financial reports. It is well documented in the financial literature that earnings are managed

¹ Vatican has issued a statement favoring Islamic finance; Japan has made amendment in laws to provide level playing field for Islamic finance; Hongkong has changed law to facilitate Islamic law; Iran and Sudan has switched total economy to Islamic finance; Fast growth in assets under Islamic finance have been depicted in Pakistan, Bangladesh, Saudi Arabia, United Arab Emirates and UK.

(manipulated) by opportunistic managers to gain some preset objectives. Availability of true and fair profit figure and trust among the parties are essential elements in profit and loss sharing business.

How Islamic finance developed?

Perhaps all efforts and experiences done in this regard are not well documented and accessible; however, some of the initiatives are presented hereunder, which paved the way for the establishment of modern Islamic banking. Although precise movements and courses of actions to transform economies as per Islamic worldview in Muslim countries appeared publicly in the early 1970s, however, voices against the prevailing financial system appeared much earlier. In the Indian subcontinent, scholars (Iqbal and Maudoodi), while in the Arabian region (Al-Sadr and Qutb) declared dealing in banking interest illegitimate for Muslims and voiced for an economic system as per Islamic teachings before the 1950s (el-Gamal, 2003). While discussion on the theoretical underpinning of Islamic banking and finance started during the 1950s, a few practical steps were taken in Egypt and Malaysia in 1960s [*Mitghamr* Saving Associations (1961–1964) and establishment of *Tabung Haji* in 1962]. It is also said that at the same time, an Islamic bank was also offering services in Pakistan, but the author could not find a written source. Malaysian *Haji* financing program [*Tabanh Haji*] proved very successful and paved the way for the establishment of a full-fledged Islamic bank.

Beginning from the period of liberation from colonial powers, specific notable reform movements towards Islamisation started in Muslim societies, including Pakistan, Iran, Sudan, Turkey, Egypt, and Algeria². The Muslim socio-political thinkers, including Iqbal, Moudoodi, Al-Banna, Qutb, Khomeini, and Erbakan imparted significant influence on Muslim masses. These leaders formed associations to disseminate the message of *Shari'ah* and its application in modern societies. Although, none of these leaders except Khomeini could reach the power corridors, however, their literature influenced the Muslim thought process significantly. The pressure of these movements resulted in the inclusion of *Shari'ah* law supremacy in constitutions of several modern Muslim states. In Pakistan, Iran and Sudan, specific efforts by the governments of respective countries have made to transform the economy as per the Islamic financial system³. Credit

Islamic Development Bank

Up to June 1992 capital of IDB was just 2 billion Islamic Dinars [ID], which is now reached to ID 30 billion with a paid up capital of ID 15 billion. IDB has 56 members with the basic criteria to have OIC membership. IDB's head office is located in Jeddah, KSA with four regional offices in Morocco, Malaysia, Kazakhstan and Senegal. IDB Bank extends loans to its member countries for the financing of infrastructural and agricultural projects such as roads, canals, dams, schools, hospitals, housing, rural development, etc. both in the public and private sectors, which have an impact on the economic and social development of the member countries concerned and are accorded priority by the Governments concerned.

² For example, Jamaat e Islami-Pakistan, Akhwan al Muslimeen-Egypt, Islamic Salvation Front-Algeria, Millî Görüş-Turkey and Revolutionary Movement-Iran.

³ Pakistan, Sudan and Iran announced the adoption of Islamic financial system officially in the 1980s. The enthusiasm failed in Pakistan, primarily, on account of lack of trained human resources and conventional practices continued under this disguise of Islamic finance. In the 1990s the matter taken into higher courts and finally a detailed judgement was issued by Supreme court of Pakistan, declaring the prevailing financial practices Haram. From 2000-onward Pakistan adopted the strategy of the dual banking system, like many other Muslim countries.

goes to these movements to an extent for overwhelming acceptance and positivity in sentiments about Islamic financial system among Muslim customers.

The milestone in the development and implementation of Islamic financial system was the conference of Finance Ministers of Organization of Islamic Conference (OIC), December 1973, in Jeddah, whereby the decision to establish Islamic Development Bank (IsDB) was taken place. Islamic Development Bank was formally opened in October 1975 with the purpose

“to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari’ah, i.e., Islamic Law.”

There are 57 IsDB members around the world. IsDB is engaged in the development process of member communities by providing required financing for various projects, including infrastructure development. IsDB group consists of multiple entities engaged in the provision of services in the areas of research and training, export credit insurance; development of the private sector, international trade financing and *waqf*-based socioeconomic services (<https://www.isdb.org>). IsDB uses loan financing, technical assistance, leasing, instalment sales, *Istisna’a*, lines of financing, equity participation, *Murabaha* and profit-sharing as financing models while extending financial services to its customers/members. IsDB either shares profit or charges profit or service fee to recover expenses of the bank as a reward for the provision of financing and technical services.

With the establishment of IsDB, Islamic finance started expanding with support from OIC member communities. Research works begun/enhanced to present an alternative banking model free from interest. In 1980 first-ever landmark report on “Elimination of *riba* from the Economy” came on the surface, written by Council of Islamic Ideology [CII] Pakistan. CII report got political support from the Pakistani government and Pakistan started the Islamisation process of the economy in the early eighties. Meanwhile, a revolution took place in Iran; and Iran switched its operations to interest-free banking, economy-wide. Simultaneously, individual institutions started Islamic banking in the Gulf region, including Faisal Islamic Bank, Albaraka Islamic Bank, and Dubai Islamic Bank.

In order to standardize the products and services offered by Islamic finance industry in light of *Shari’ah*, specific international bodies played a significant role. These international bodies present collective wisdom of industry players and *Shari’ah* scholars. A brief review of such collective forums is presented in this section.

Islamic Fiqh Academy (IFA), Jeddah, was established under auspices of OIC in 1983 with the objective to offer Islamic solution to challenges of modern life by consolidated efforts of Muslim intellectuals. IFA has issued numerous ‘*Resolutions*’ (considered opinions) which helped in strengthening the modern IFSI in light of *Shari’ah* percepts (<http://www.iifa-aifi.org>).

In 1991 Accounting & Auditing Organization for Islamic Financial Institutions [AAOIFI] was established with the mission to standardize and harmonize Islamic finance practice and financial reporting following Islamic law, globally. It is registered in the state of Bahrain. The organisation is engaged in the provision of services in the area of standardization of products offered by Islamic financial institutions. AAOIFI has focused on multiple areas of its jurisdiction like issuance of *Shari’ah* Standards—explaining the Islamic jurisprudence in the area of modern business settings; and Accounting, Auditing and Governance Standards—outlining the Islamic law’s application in these areas. AAOIFI has two boards known as *Shari’ah* standard board which approves *Shari’ah* standards while accounting & auditing standard board approves accounting, auditing & governance standards

in addition to code of ethics. By 2015, AAOIFI has issued 54 Shari'ah standards, 24 accounting standards, five auditing standards, seven governance standards and two code of ethics (<https://aaoifi.com/?lang=en>).

Islamic Financial Services Board (IFSB) was established in 2002 in Malaysia. IFSB issues professional standards on capital adequacy, corporate governance and risk management for the smooth running of the industry in light of *Shari'ah* principles. It covers professional practices in Islamic finance with a focus on banking, *takaful* and capital market. IFSB membership base is spread over 57 jurisdictions and includes regulators (79), international inter-governmental organisations (8), and market participants (95)—financial institutions, professional firms, industry associations and stock exchanges. So far, IFSB has issued 30 standards focusing on risk management and corporate governance, etc. (<https://www.ifsb.org>).

International Islamic Financial Market (IIFM) was established in 2002 in Bahrain with a vision to pursue well-regulated trading of *Shari'ah* compliant financial instruments. IIFM has 64 members, including central banks, commercial banks, stock exchanges and others. The IIFM has issued so far 12 standards covering multiple areas of financial markets (<https://www.iifm.net>).

During the last quarter of 20th-century, serious efforts were made for the promotion of the Islamic financial system in Muslim societies as well as throughout the world in general. This journey has been continuing in the 21st century as well. Islamic finance had shown resilience to the Global Financial Crisis (GFC) in 2007-08; an era of the economic downturn in developed countries, including the United States and Europe. Assets of Islamic finance had grown at the rate of 38% and 25% in 2007 and 2008 respectively, an era of economic recession in developed economies.



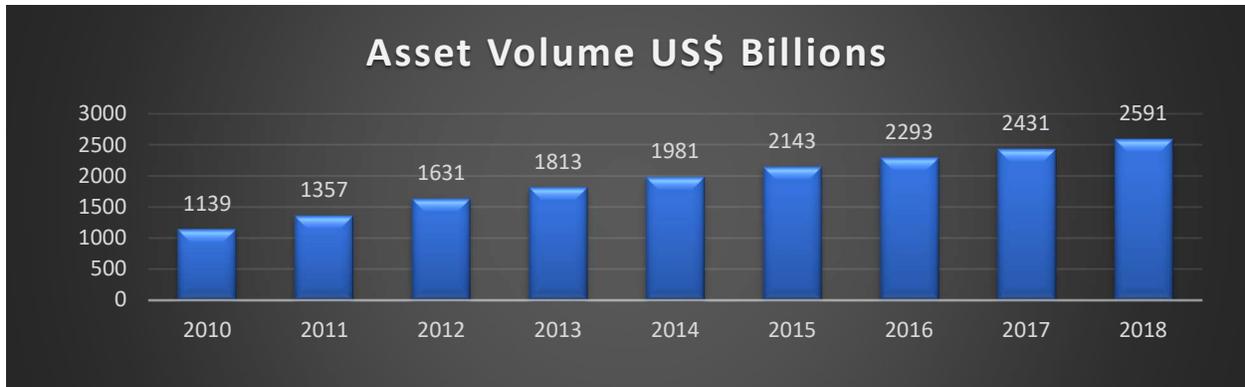
Badshahi [Royal] Masjid, Lahore

What is the present status of Islamic finance industry?

The global volume of assets under the Islamic financial system has reached the figure of US\$ 2.5 trillion by the end of 2018 (potential size is above US\$ 9.0 trillion), depicting average yearly growth around 16% from 2010-18 [GIFR-2019]. [Industry size estimation by IFSB report (2019) [2.19 trillion] varies from GIFR-2019]. Within eight years, the industry volume of assets is more than double. However, the increase in assets is not even for all the years. In earlier years [2011-14] average annual growth rate is 18.48% while in later four years [2015-18] yearly average growth rate is 7.69%, signifying the reduction in growth in assets under management of Islamic financial system.

Under conventional financial system financier is earning risk free return in the form of interest while under Islamic financial system opportunity of risk free return does not exist hence increasing the risk exposure of IFIs.

Industry Progress 2010-18



Source: Global Islamic Finance Report-2019

Although growth is positive, however, the potential is very high. GIFR 2019 estimates the potential size of the industry above US\$ 9.0 trillion and catch period to realize the potential is estimated close to 40 years. Islamic finance expands in allied financial sectors, including insurance, capital market operations (equity and *Sukuk*) and microfinancing in addition to the traditional banking sector. However, dominant share in assets under Islamic financial system is concentrated in the banking sector. According to IFSB (report-2019) share of banking in global Islamic financial services industry [volume 2.19 trillion] is 71.7%, followed by capital market operations with 27% [*Sukuk* 24.2% & Islamic funds 2.8%] and Islamic insurance (*Takaful*) 1.3%. Although it was started as merely an alternative option for *Halal* financing, now it has become a complete financial solutions industry and expanding day by day. There are multiple *Sukuk* [Islamic bonds] issues, including private and public sectors, alike. Islamic indices based on *Shari'ah* compliance filters are developed globally in Muslim and non-Muslim countries. Firms engaged in screening of *Shari'ah* compliant equities include DJIM, S&P, MSCI, FTSE and Bloomberg in addition to multiple country-specific Islamic indices.

The geographic concentration of Islamic finance is primarily in OIC-region from Indonesia to



The second full-fledge Islamic Commercial Bank in Pakistan, was incorporated on October 18, 2004 in Pakistan. BankIslami Pakistan Limited made a public offering of Rs. 400 Million, at par, from 6th to 8th March & received overwhelming response from the general public as the applications received were 9 times higher than offered, fetching nearly Rs. 3.5 Billion, against the demand of Rs. 400 Million. As at June 2013, it has branch network of 142. BankIslami offers retail, corporate, investment banking as well as Takaful services.
[bankislami.com.pk]

Morocco; however, the UK has shown some progress from the European region. Important regions which contribute in global Islamic financial services industry include GCC (42.3%), Asia (28.2%), MENA-ex GCC (25.1%) and balance (4.4%) from rest of the world [IFSB-2018]. Arabian Gulf area is the centre of modern Islamic financial system with a significant share in global Islamic banking assets, followed by South and Southeast Asia (Statistics in appendix). Arabian gulf region includes SIX GCC (Gulf Cooperation Council) countries—Kuwait, Bahrain, Saudi Arabia, Qatar, UAE and Oman—plus Iran. In the Gulf region, there are 92 Islamic banks with a vast branch network of above 22,000. Above 250,000 people are directly employed by the Islamic banking sector. Total assets under management of Islamic banking amounting to US\$ 1,582 billion, while providing financing of US\$ 842 billion. Gulf region is Centre of Muslim civilization and



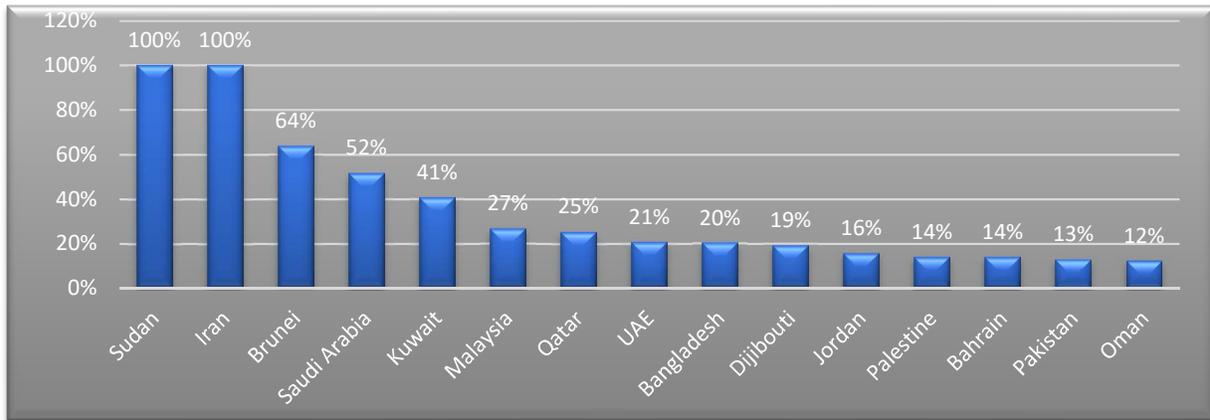
Meezan Bank Limited, a publicly listed company, was incorporated on January 27, 1997 and started operations as an investment bank in August that year. In January, 2002 in an historic initiative, Meezan Bank was granted the country's first full-fledged commercial banking license as a dedicated Islamic Bank, by the State Bank of Pakistan. The Bank's deposits grew at an average rate of 46% p.a. from December 2002 to December 2012 while its branch network grew from 6 branches in 2002 to 328 branches in October 2013, an average growth rate of 48% p.a. Meezan Bank awarded 'Best Islamic Bank in Pakistan' for 2013 by Asiamoney, Hong Kong [meezanbank.com]

remained Muslim controlled area since the advent of Islam in the 7th century.

South and Southeast Asia (S&SA) region include FIVE Muslim nations [with Islamic finance]—Indonesia, Brunei, Malaysia, Bangladesh, and Pakistan. Based on the volume of assets under the Islamic banking system, the region is placed as second. Total assets under management of Islamic banking amounting to US\$ 294 billion, while provided financing of US\$ 216 billion. In S&SA region there are 107 Islamic banks with a branch network of above 9,450. Around 240,000 people are directly employed by the Islamic banking sector. S&SA consists of a significant Muslim population. Indonesia and Pakistan are top in the list with largest Muslim population, respectively.

IFSB (Islamic Financial Services Board) identifies systematically important jurisdictions for the Islamic banking system in its annual report—Islamic finance stability report-2019. A country with a volume of assets under the Islamic banking system reaches 15% share in total domestic banking assets is considered systematically important. As per the ranking, 12 countries qualify the mark of 15% or more banking assets under the Islamic banking system. The list includes Iran and Sudan (100%), Brunei 64%, Saudi Arabia 52%, Kuwait 41%, Malaysia 27%, Qatar 25%, UAE 21%, Bangladesh 20%, Djibouti 19% and Jordan 16%. Bahrain and Palestine are 1% less than the target of 15%, while Pakistan and Oman are next in line. The 12 [including Bahrain] systematically important jurisdictions contribute 91% to the global Islamic banking assets and host 80% of the global Sukuk outstanding in 2018.

Country-wise Islamic banking share domestic banking Assets



1.2. RIBA (INTEREST AND USURY)

In Arabic terminology, *Riba* is used for an incremental amount charged over a transaction of the loan as a predetermined return. Charging of usury and interest is *Haram* in Abrahamic religions including Judaism, Christianity and Islam⁴. Charging of additional predetermined amount (usury, interest) on loans had never got support in ethics/religions. Interest charging is forbidden by at least all known revealed faiths including Judaism, Christianity and Islam. Following are six verses cited by Usmani, (1999), from the Old Testament of The Bible.

1. "Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything that is lent upon usury." [Deuteronomy 23:19]
2. "Lord, who shall abide in thy tabernacle? Who shall dwell in thy holy hill? He that walketh uprightly, and worketh righteousness and speaketh the truth in his heart. He that putteth not out of his money to usury, nor taketh reward against the innocent." [Psalms 15:1, 2, 5]
3. "He that by usury and unjust gain increaseth his substance, he shall gather it for him that will pity the poor." [Proverbs 28:8]
4. "Then I consulted with myself, and I rebuked the nobles, and rules and said unto them, Ye exact usury, every one of his brother. And I set a great assembly against them." [Nehemiah 5:7]
5. "He that hath not given forth upon usury, neither hath taken any increase, that hath withdrawn his hand from iniquity, hath executed true judgment between man and man, hath walked in my statutes, and hath kept my judgments, to deal truly; he is just. He shall surely live, said the Lord God." [Ezekiel 18:8.9]
6. "In thee have they taken gifts to shed blood; thou hast taken usury and increase, and though hast greedily gained of thy neighbors by extortion, and hast forgotten me, said the Lord God." [Ezekiel 22:12]

According to Usmani, 1999, "The word *riba* used in the Holy Qur'an carries the same meaning [as word usury] because the verse of *Surah Al-Nisaa* explicitly mentions that *riba* was prohibited for the Jews also".

In The Holy Qur'an, four sets of verses are about *riba* (interest) revealed on different occasions. Translation of the verses⁵ is presented here in the order of revelation.

1. The first verse is in *Surah Al-Rum* 30:39, whereby displeasure of Allah is disclosed for interest-based practices. "And whatever *riba* you give so that it may increase in the wealth of the people, it does not increase with Allah."
2. The second verse is in *Surah Al-Nisaa* 4:161, where interest charging was disclosed as a sinful act of Jews. "And because of their charging *riba* while they were prohibited from it."
3. The third verse is part of *Surah Al-i-Imran* 3:130, whereby prohibition of *riba* (interest) was declared "O those who believe do not eat up *riba* doubled and redoubled."

⁴ Author has benefited from supreme court of Pakistan decision on *Riba* in 1999, written by Justice M Taqi Usmani, in writing this section. Readers interested in knowing more on the topic may access the full text:

[https://www.albalagh.net/Islamic_economics/riba_judgement.pdf]

⁵ Translation adopted from Usmani, 1999.

4. The last set of verses revealed is reported in *Surah Al-Baqarah* 2:275-281, whereby severe punishment is declared for those dealing in interest and also persuaded for charity, deferment of loans from miser persons and even write-off as alms.

"Those who take interest will not stand but as stands whom the demon has driven crazy by his touch. That is because they have said: 'Trading is but like riba'. And Allah has permitted trading and prohibited riba. So, whoever receives an advice from his Lord and stops, he is allowed what has passed, and his matter is up to Allah. And the ones who revert back, those are the people of Fire. There they remain forever" [2:275]

"Allah destroys riba and nourishes charities. And Allah does not like any sinful disbeliever" [2:276]

"Surely those who believe and do good deeds, establish Salah and pay Zakah, have their reward with their Lord, and there is no fear for them, nor shall they grieve" [2:277]

"O those who believe, fear Allah and give up what still remains of the riba if you are believers" [2:278]

"But if you do not, then listen to the declaration of war from Allah and His Messenger. And if you repent, yours is your principal. Neither you wrong, nor be wronged" [2:279] "And if there be one in misery, then deferment till ease. And that you leave it as alms is far better for you, if you really know" [2:280]

"And be fearful of a day when you shall be returned to Allah, then everybody shall be paid, in full, what he has earned. And they shall not be wronged." [2:281]

There are two types of *riba* discussed in the literature, including usury [on consumption loans] and interest [on productive loans]. What is meant by *riba* used in the revelations? Whether it is usury? Interest? Or both? In this section, the meaning of term *riba* as used in the Arabic language; and literature about its prohibition, is presented. In Arabic terminology, *riba* is a synonym for the term interest used in conventional banking operations covers both consumption loans [usury] and productive loans [commercial interest]. *Riba* means charging predetermined additional amount on loan extended based on the length of the credit period. Certain quarters are of the view that *riba* which is prohibited by revelations is the usury (interest charged on consumption loans), and the term does not cover banking interest (interest charged on productive loans). This point was debated in detail during the Supreme Court (Pakistan) hearing and concluded that there was no difference between usury and interest as for prohibition is concerned. Following are some further citations (definitions) extracted from literature to clarify the meanings of word *riba* used in Holy Qur'an.

1. In the words of Imam Abubakr Al-Jassas (D.380 AH)⁶ "The riba of Jahiliyya [period of ignorance] is a loan given for stipulated period with a stipulated increase on the principal payable by the loanee [the debtor]."

2. Extract from the decision of Supreme Court of Pakistan is presented as under:

"It is thus clear that the permissibility of interest can neither be based on the financial position of the debtor, nor on the purpose for which money is borrowed, and, therefore, the distinction between consumption loans and productive loans in this respect is contrary to the well-established principles" (Usmani, 1999 Para 72).

While deciding the issue of banking interest as permitted or prohibited in Islam, the Supreme Court (Pakistan) declared: "Any additional amount over the principal in a contract of loan or debt is the *riba* prohibited by the Holy Qur'an in several verses" (Usmani, 1999; Para 242).

3. Islamic Fiqh Academy India⁷ explains:



⁶ As cited by Usmani, (1999)

⁷ http://ifa-india.org/english/arabic_Words.html accessed on 20th March, 2010.

“riba (interest) is a very important term in the Islamic terminology showing disapproval and it refers to the instrument by which a loaner [creditor] charges some amount lump sum or in installments over and above his principal amount from the loanee [debtor] and thus increases his wealth manifold without participating in the business process of profit and loss”.

4. Siddiqi, (2004), concludes that unanimous view of Muslims throughout history remained is—any excess charge in a contract of loan is riba—and bank interest has no exception.

5. Islamic Fiqh Academy (IFA), Jeddah, of OIC representing the collective wisdom of *Shari’ah* experts, is of the view that any increase stipulated in a contract of loan irrespective whether consumption loan or productive loan is *riba* prohibited by Allah (SWT). Iqbal, & Molyneux

document "The equivalence of riba to interest has always been unanimously recognized in Muslim history by all schools of thought. In conformity with this consensus, the Islamic Fiqh Academy of the Organization of the Islamic Conference (OIC) has recently issued a verdict in its Resolution No. 10(10/2) upholding the historical consensus on the prohibition of interest" (p. 9; IFC/2000)⁸.



Instructions are clear. No ambiguity is left. If a person believes in Revelations, then s/he should avoid charging interest and seek the pleasure of Allah (SWT).

It is the responsibility of all true believers in God (especially, followers of Abrahamic religions including Jews, Christians, and Muslims) to give up interest-based transactions from their personal lives, immediately, and use their energies collectively to design, promote, and implement a financial system free of interest. Following conclusions are drawn from the above citations:

First; Interest is prohibited by all revealed [Abrahamic] religions and charging interest is *haram* (unlawful) for [at least] Jews, Christians and Muslims.

Second; as far prohibition of interest is concerned, there is no difference in commercial loans, and consumption loans at all and bank interest is *haram* (unlawful).

While it is clear from the above citations that dealings in interest-based transactions are *haram* (unlawful) including conventional banking, however, the critical role of commercial banks cannot be rejected in the modern economy; so the change in the philosophy and design of commercial banking was required to meet the religious obligation. Referring to the above citations, it is further concluded that what is prohibited through revelations, is the pre-determined charge on capital (risk-free return), and not the profit (involving risk) on capital invested (2:275). Muslim Jurists are of the opinion/view that reward for money should be linked with the outcome of the underlying project if financing facility is being extended; and/or reward should be obtained through trades involving sales and purchases. It is pertinent to note that the Islamic financial system aspires for financial stability through linkage of real and financial sectors as well as equitable wealth distribution through actual profit and loss sharing and access to finance. How much it succeeds, only time will tell; however, goals are appreciable.

⁸ <http://www.globalwebpost.com/farooqm/writings/islamic/r-i-consensus.html> accessed on March 20th 2010.

1.3. BUSINESS MODEL OF ISLAMIC FINANCE

While interest and usury are not allowed under Islamic financial system; and reason to establish a new financial stream is to avoid interest, an interesting question emerges as what is the business model of Islamic commercial finance. Islamic finance is not a charitable economic activity; instead, it is a commercial enterprise, albeit within the constraints of Shari'ah (Islamic values). Islamic finance models can be categorized, objectively, as asset-based financing; actual profit and loss sharing financing; capital market operations (equity and Sukuk); and fee-based services. In the following paragraph, a very brief introduction of these business models is provided.

1.3.1. Asset-based Financing

Asset-based financing includes either sale/purchase of assets [to earn profit] or provision of assets for rental income. There are multiple types of sales available to modern Islamic financial system, including following. As the Islamic financial services industry is established to manage finances in the economies, hence, practically most of the sales of assets are completed on a deferred basis, as opposed to spot exchange of counter values.

Murabaha Financing: *Murabaha* is a cost-plus-profit sale contract whereby disclosure of cost to the buyer is necessary. Under *Murabaha* arrangement customer requests to the Islamic Financial Institution (IFI) to purchase an asset for him (customer) and sell on deferred payment. An essential feature of *Murabaha* is that IFI must buy the required commodity from supplier first and then sell to the customer. Bank charges a certain profit usually linked with Inter-Bank Offered Rate. Recovery of receivables could be agreed in instalments or Balloon payment. The amount of instalment or price of the asset cannot be (stipulated) increased or decreased in case of default or early payment (Shari'ah standard 8). To create pressure on the client for prompt payment, a penalty is imposed upon the customer as agreed in the *Murabaha* contract. The amount of penalty, for default in timely payment, recovered cannot be included in the income of IFI in any case and must be spent for charity (Usmani, 2002). *Murabaha* has successfully replaced the overdraft and short-term loans facility under conventional banking.

Murabaha is a cost-plus sale contract whereby disclosure of cost to the buyer is necessary.

Salam Financing: *Bai e Salam* is a form of sale contract whereby IFIs purchase goods for spot payment with delayed delivery. Practically it is used in the financing of agricultural needs of farmers. Farmers sell their crops before harvesting to IFIs in order to get money to purchase seeds and fertilizers, etc. Generally, spot price agreed is lesser than the future price (the actual date of delivery); hence IFIs make profit. As a matter of practice, IFIs are entering into a parallel Salam contract with the third party to sell the proceeds once taken over; however, execution of the second contract is not conditional on the fulfilment of first (Sh. St. 10).

Bai Muajjal: The literal meaning is deferred / credit sales. Islamic Financial Institutions (IFIs) carry the option to use this mode to finance the customers' needs by the supply of desired commodities. The difference between *Murabaha* and *Bai Muajjal* lies in the disclosure of cost to the customer.

Under *Bai Muajjal* cost may or may not be disclosed; however, disclosure is not mandatory. All other features are the same as discussed in *Murabaha*.

Istisna'a Financing: *Istisna'a* is a sales-type relating to manufacturing. This mode of financing is designed to transact business through an order to manufacture and/or supply. It is a sales contract with the exception of the existence of subject matter. This tool of financing is useful for infrastructure projects. Parallel *Istisna'a* contract is allowed; however, the performance of second *Istisna'a* contract must not be conditional on the fulfilment of the first contract (Shari'ah standard 11).

Ijarah Financing: *Ijarah* is a rental contract whereby IFI leases an asset for a specific rent and period to the client. Ownership risks of the asset are borne by IFI, while expenses relating to using the asset are the responsibility of the client. The difference between *Ijarah* and sale is that ownership in *Ijarah* remains with lesser while in the case of selling it is transferred to the purchaser. Ending *Ijarah* in the sale of the asset is allowed by IFA through a separate contract at the completion of the term of the lease. The agreement can be executed before the purchase and possession of the asset. Consumables cannot be leased out. Right of the lessee to use the asset is restricted to lease agreement or/and as per the normal course of business. Lessee is liable for any harm to the asset caused by any misuse or negligence on his part. Rentals of joint property are shared according to equity. A joint owner can rent his share only to the co-partner. Inter Bank Rate can be used as a benchmark for the amount of rentals. At the completion of the *Ijarah* term, either asset is returned to IFI or purchased by the client (Shari'ah standard 9). *Ijarah* has replaced the facility of leasing under the conventional financial system successfully.

Above mentioned financing tools leads to the creation of debt hence known as *Shari'ah* compliant (permitted but not preferred), as opposed to desired modes of financing, which are equity-based and known as *Shari'ah* based. *Shari'ah* compliant products mean the methods of funding where the return of financier is predetermined and fixed but within *Shari'ah* constraints. These financing tools harmonise, relatively, the operations of the Islamic financial system with conventional banking

1.3.2. Profit and Loss Sharing

Shari'ah based transactions mean the financing modes adopted by IFIs on profit and loss sharing basis, including *Musharakah* (partnership in the capital) and *Mudarabah* (partnership in capital and skill). Under *Shari'ah* based modes of financing returns of a financier are not fixed in advance; rather, it depends upon the outcome of the project. However, the loss is to be shared according to the capital contribution, as per Islamic law.

Musharakah Financing: According to *Hadith Qudsi* (revelation reported by Prophet Muhammad PBUH) "Indeed, Allah the Exalted says: I am the third of the two partners so long as the one does not cheat the other, and when he cheats, I withdraw myself" (Khan, 1989). The literal meaning of *Musharakah* is sharing. Its root in the Arabic language "*Shirka*" means being a partner. *Musharakah* means a joint enterprise formed conducting some business in which all partners share the profit according to the pre-agreed ratio. In contrast, the loss is divided according to the proportion of contribution (Meezan Bank guide 2002). For an ultimate *Musharakah* fulfilment of certain conditions is required. First is there must be an agreement written (verbal) among the partners stating clearly the terms and conditions including management, capital contributions, profit and loss sharing among the partners. Second capital can be contributed in cash as well as in assets. However, once an asset

is provided as capital that belongs to the firm and contributing partner is relieved from the bar of risks and returns attached to ownership. Third profit is distributed according to the agreement of partnership; however, the sleeping partner cannot claim a share in profit more than his proportionate share in equity. None of the partners can guarantee the capital or profit share to any other partner (Shari'ah standard 12). Under *Musharakah* IFIs are receiving deposits and finances business requirements for profit and loss sharing.

Diminishing Musharakah: Diminishing *Musharakah* is a form of declining partnership between IFI and client generally used to finance real estates. When a customer requests to IFI for financing to purchase an asset, IFI participates in the ownership of the asset by contributing required finance. The customer must provide a Certain portion (e.g. 20%). Total equity of the bank is divided into units of smaller amounts which are purchased by the client in instalments. Under this mode of financing, one of the partners (client) promises to buy the equity share of the other partner (IFI) gradually until the title to the equity is completely transferred to him. Buying and selling of equity units must be independent of the partnership contract and must not be stipulated in the partnership contract. Generally, IFI rent out his share to the client and earns rentals. Any profit accruing on the property is distributed among the co-owners according to agreed ratio; however, losses must be shared in the proportion of equity (Shari'ah standard 12). Diminishing *Musharakah* is used for house financing by IFIs and has replaced conventional mortgages successfully.

Mudarabah Financing: *Mudarabah* is a type of partnership whereby skill and money brought together to conduct the business. Profit is shared according to an agreement while the loss is borne by capital provider only. Under this scheme of financing, IFIs provide capital to financially weak but skillful people to do the business and share the outcome with IFIs. This scheme is also used in deposit collection. *Mudarabah* contract can be restricted or unrestricted. No one can claim a lump sum amount of profit it must be based on actual outcome (Shari'ah standard 13).

To penalize the defaulters, Ulama (clerics) have allowed IFIs to charge a penalty; but same cannot form part of income of IFIs rather it goes into charity.

Following the rule of substance over form, one can conclude that the significant difference between conventional and Islamic financing is *Shari'ah* based modes of financing. By looking at portfolios of IFIs working, globally, it is inferred that share of *Shari'ah* compliant funding modes is dominant with a lesser portion invested in *Shari'ah* based modes. Portfolios of global Islamic banking industry carry different ratios of application of profit & loss sharing contracts in financing. Iran is leading with 53%, followed by UK 34%; South Asia 12%; Southeast Asia 10%; and GCC less than 1%. Overall share of profit and loss sharing contracts in portfolios of global Islamic banking industry is 21% in 2018 [see appendix]. This is an issue which demands the serious attention of industry leaders as well as policymakers. Practitioners of IFIs have focused so far on asset-based financing with a share in portfolio close to 50% [*Murabaha*, commodity *Murabaha/Tawarruq, Salam and Ijarah*]; debt creation tools and similar to conventional banking, to an extent. Of course, the differences lie in nature of contracts including the bearing of ownership risk by IFIs, no extra charges for late payment, no interest charging, linkage of the financial and real sector, etc. however returns of IFIs are absolute and pre-calculated. One of the significant reasons for the lesser popularity of Profit and loss sharing (PLS) system is a lack of human resources equipped with updated knowledge of Islamic financial

system. Most of the officers working in the Islamic financial industry are trained in conventional banking and lacking the philosophy and understanding of Islamic banking, severely.

Hanif, & Iqbal, 2010, conclude that the major hurdle in the popularity of *Musharakah* financing is the dominance of conventional banking, and this hurdle can be removed only through the expansion and growth of IFIs. Other factors discouraging *Shari'ah* based financing, identified in their study, include the higher risk level in *Musharakah*, profit manipulation behaviour of businesses, lack of trust and confidence in the ability of *Musharakah* partners, manipulations of accounts by firms under conventional accounting framework, relatively higher taxes, weaker auditing and lack of awareness among masses about the philosophy and operations of IFIs. Through increased awareness, grants of tax incentives, capacity building of IFIs, strengthening audit institution, fostering by central bank and new products development with a focus on small and medium enterprises under *Musharakah* principles, *Shari'ah* based financing can be promoted.

1.3.3. Capital Market Operations

Capital market operations are divided into two subsections, including dealing in equities and dealing Sukuk (bonds).

Equity Securities: As a matter of fact, equity capital markets work on the basis of profit and loss sharing, hence, complementary to the Islamic financial system. However, certain questionable practices from *Shari'ah* perspective are to be avoided while dealing in securities. According to AAOIFI *Shari'a* standard # 12, 17, 20 & 21 except few activities, its operation is in line with *Shari'ah* teachings. Following activities are specifically needed to be avoided by Islamic investors. Dealing in preference shares; Tmattu' shares; Futures; Options; Swaps; Purchase of shares through interest-based loans; Margin sale; Short selling; Lending of shares; Application of *Salam* contract in the purchase of equities; Renting of stocks and Trading of interest-based bonds. As for trading in other equities is concerned; still, IFIs have to apply *Shari'ah* compliance filters to determine the *Halal* status of an investment. There are multiple agencies engaged in the screening of equities, globally, with some differences in screening criteria. I present here AAOIFI filtering screens.

- a. The core business of the company should be *Halal* (not prohibited by Islamic Law such as liquor, pork, and pornography, etc.)
- b. Illiquid assets should be at least equal to 30% of the total assets of the company. Shares of a company merely dealing in liquid assets are not *Shari'ah* compliant [except trading at par value]; hence, IFIs need to refrain from investment.
- c. The ratio of all interest-based debts, including preferred stock, should be less than 30% of the total assets of the company.
- d. The ratio of non-*Shari'ah* compliant investments to total assets of the company should be less than 30%.
- e. Revenue from non-compliant investments should be less than 5% of the total revenue of the company, and even then IFIs are required to purify their earnings by spending this noncompliant revenue as a charity.

Sukuk Bonds: *Sukuk* bonds is a creative innovation by the Islamic financial system. *Sukuk* are designed to replace the conventional interest-based bonds. *Sukuk* bonds are the avenue for low risky investors intending to earn a regular stream of earning. As per design *Sukuk* are ownership certificate in real

assets (like building, road, bridge, etc.) and or a portfolio of assets with dominant contribution from real assets (e.g. a business). There are multiple types of *Sukuk*, including *Ijarah*, investment, *Murabaha*, *Salam*, *Musharakah*, etc. with specific designs. Focusing on the *Sukuk* type, which provides relatively fixed earnings (*Ijarah Sukuk*), very close to conventional bonds in return, the model suggests the sale of an asset to *Sukuk* holders for a price. The total value of the underlying asset is divided into multiple ownership certificates offered for sale to investors. The asset is leased back by the seller for fixed periodic rentals, usually linked with the interbank offered rate for the term of the *Sukuk*. Regular rentals are paid to investors according to the equity stake in the asset for the duration of the *Sukuk*. The asset is taken back through buy-back agreement at the completion of the term of the *Sukuk* and certificates are redeemed.

1.3.4. Islamic Insurance

The basic concept of insurance activity is cooperation among the participants to distribute the loss by one person among the group. However, over the centuries, conventional insurance has become a speculative business of guaranteeing the loss of individuals by insurance companies. Modern conventional insurance operations are contradictory with Shari'ah teachings on account of two reasons, including *gharar* (excessive risk) and *ribā* (interest). *Gharar* emerges when insurance company buy the risk of another entity for premium and *ribā* involves in interest-based investment avenues. Islamic insurance revives the concept of mutual cooperation in insurance activities. It is a commercial operation from an insurance company perspective, but it is a cooperative venture from the customers' perspective. According to the design of *takaful* insurance, customers contribute premium to a participatory fund which is used to pay the compensation to members based on stated rules and procedures. Insurance company earns a commission from premium paid by the customer to manage insurance operations. Simultaneously, money in the participatory fund is invested by the insurance company following the *Mudarabah* or *Wakalah* contract, as the case may be. Under *Mudarabah* contract insurance company shares in profit, however, the loss is charged to the participatory fund only, and insurance company gains nothing for the investment services. Under *Wakalah* model insurance company receives a fee for investment services irrespective of profit or loss on investments. *Mudarabah* model is superior to *Wakalah* to address the issue of moral hazard as well as an incentive for the insurance company to work harder. *Takaful* insurance model is applicable to all sorts of insurance needs of modern business and industry, including transit, assets, medical as well as life insurance. Under life insurance (family *takaful*), there are two suggested models, including compensation in case of death of an insured person as well as compensation plus investment. In the earlier case, a lesser amount of premium is charged, and the claim is entertained in case of death. While in later case higher premium is charged to distribute the money in between insurance account and investment account. Like insurance account (participatory fund) money in investment accounts of customers is invested by the insurance company on *Mudarabah* basis, and profit is distributed among the customers and insurance company as per profit sharing ratio. Hence, *takaful* insurance provides both incentives for death compensation as well as retirement benefits.

Underlying principle in issue of Sukuks is that illiquid assets should dominate in the portfolio against which Sukuks are issued.

1.3.5. Socioeconomic Services

Islamic finance is expected to promote socioeconomic services, including the transfer of wealth from rich to poor as well as access to financing by low income unserved/underserved segments of the society. Additionally, Islamic finance is expected to provide services to agricultural and rural economies through microfinancing. Also, Islamic finance is expected to serve the community through the management of charities including Zakah, waqf, and other charitable programs in the area of poverty reduction, health and education. Islamic financial system had some contribution to the collection and distribution of Zakah. Additionally, certain charitable incomes generated in the process of interaction with the broader financial sector and late payment penalties charged to the customers. These amounts form a significant portion, globally, which are disposed of in charitable activities including education by Shari'ah boards of respective organizations. However, expectations from Islamic finance are very high in the area of financial stability through linking real and financial sectors, equitable distribution of wealth through the application of profit and loss sharing and ensuring access to finance to low-income sections of the society. Furthermore, management of charitable operations including Zakah, waqf and other charity schemes including qard e hasan, poverty reduction, self-employment fall within the scope of Islamic financial management.

1.4. SALIENT FEATURES OF ISLAMIC FINANCE

Although the practice of charging interest by conventional banking was a major factor which led to the development of Islamic banking, however, it is not only the avoidance of interest which can make a conventional bank as Islamic. When we talk about Islamic banking, it means following of Islam in all spheres of business including but not limited to following:

1. The principal activity of the customer of Islamic financial institutions (IFIs) must not be prohibited by Islamic *Shari'ah*. To mention few, Islamic banks cannot receive the deposit or extend the financing for the business of liquor, pornography and pig farming.

2. Under partnership business (*Musharakah & Mudarabah*), IFIs cannot limit their share in profit only to safeguard the capital. IFIs are required by Islamic law to share loss as well. Furthermore, loss in the partnership must be shared according to equity stake; however, profit can be shared in any ratio subject to the limit for sleeping partner whose share cannot be more than proportionate equity stake (Khan 1989, page 71; & *Shari'ah* standard 12).

Excessive inflation which we face in less developed countries including some Muslim societies is not the direct consequence of paper currency rather it is financial indiscipline of the governments of these countries.

3. Islamic banks have to follow the principles of sales and purchase as given by *Shari'ah*, including five *khiyars* (stipulations). According to Usmani, 2002, Five *khiyars* include the following:

First, *Khiyar e Shart* (option to rescind the contract within the specific period).

Second, *Khiyar e Rojyyat* (option to inspect the article prior to purchase).

Third, *Khiyar e Aib* (option to return defective goods).

Fourth, *Khiyar e Wasf* (option to return low-quality goods if do not carry the required function).

Finally, *Khiyar e Ghaban* (option to return goods when charged a price higher than the market by deceiving buyer).

Under Islamic financial system Sukuk are ownership certificates and not mere debt securities hence all risks and rewards are shared by Sukuk holders.

4. Islamic bank cannot claim additional amount from a customer in case of default in payment at the due date; because it falls in the circle of *riba*. However, to penalize the defaulters, *Ulema* (scholars) have allowed IFIs to charge a cash penalty. Still, the same cannot form part of the income of IFIs; instead, it goes into the charity account maintained and supervised by the *Shari'ah* board of the bank.

5. Islamic banks cannot service depositors like conventional banking with a predetermined return. Deposits are taken as interest-free loans (current accounts) and refunded on demand and/or on the principle of profit and loss sharing. If any IFI accepts deposits in the current account as *Amanah* (trust), then laws of *Amanah* shall prevail including no guarantee of refund and no right to invest. It is not encouraged to collect deposits under the *Amanah* contract to protect the interest of depositors as well as the bank. Deposits for return are collected through *Mudarabah* contract, and actual outcome of operations is shared with depositors. Through the creation of specialized deposits (Restricted *Mudarabah*) for sectoral investments including real estates, agricultural products, oil sector, civil work projects, etc. IFIs can even provide a superior return to their depositors.

6. Islamic banks cannot avoid *Shari'ah* compliance in their operations on the excuse of non-conduciveness of existing legal & business framework (e.g. Islamic banks cannot demand interest on interbank deposits). Indeed, this makes the job of practitioners of Islamic financial system challenging.

7. Islamic banks cannot enter into transactions of traditional futures and forwards, gambling, and any other mode of doing business which contradicts with injunctions of *Shari'ah*.

8. For IFIs avenues are very limited to create necessary liquidity at the same time to earn some revenue by investing in the short term and liquid securities [interest-based]. IFIs cannot invest in interest-based government securities, short-term loans, bonds and money at call and short notices because of interest-based transactions. Mandatory reserve with the central bank is maintained by IFIs free of any interest-based earnings.

9. Islamic bank must avoid *Gharar* (uncertainty in price and/or delivery) in its business transactions (Ayub 2007, page 57; Mansoori 2007, page 179; Ghazi 2010, page 237).

10. Islamic banks must avoid *Maisir and Qimar* (speculation) or any game of chance (Ghazi 2010, Ayub 2007). *Maisir* is prohibited by Holy Qur'an [2: 219 and 5: 90]

11. Prohibition of interest and usury in financial dealings. Al-Qur'an (30:39, 4:161, 3:130, & 2:275-281).

12. As for investments in marketable securities are concerned again, IFIs are not free to invest in any equity security due to two reasons. First Halal business of the underlying firm is required. Second financial operations of the underlying firm should be interest-free. Keeping in view the dominance of conventional banking and existing business practices, one can conclude very safely that a very negligible number of firms meet both conditions. Islamic banks are not free to invest in the equity of any company rather have to check the *Shari'ah* compliance status of the company before investing.

To protect the interest of consumer Islamic law has given five options to buyer including option to return within specific period; if low quality goods; defective goods supplied; if substantial higher than market price charged and option to inspect prior to purchase.

Meeting of the designated tests is required to declare any equity security as *Shari'ah* compliant. There are multiple firms engaged in filtering securities with some differences in filtering criterion, including DJIM, MSCI, FTSE, S&P, etc.

13. IFIs have created an avenue to meet their liquidity requirements in the form of *Sukuk* (Islamic Bonds) whereby servicing is fixed like conventional bonds; however, such types of *Sukuk* can be issued under *Ijarah Sukuk* structure. The asset is sold to investors and leased back for a fixed period and fixed rentals. Hence, investors know the return in advance. *Sukuk* of *Murabaha* cannot be sold except at par being the sale of loans. Other types of *Sukuk* (*Musharakah* etc.) do not carry fixed return although tradable in the secondary securities market. The underlying principle in the issue of *Sukuk* is that illiquid assets should dominate in the portfolio against which *Sukuk* are issued. Under the Islamic financial system, *Sukuk* are ownership certificates and not mere debt securities hence all risks and rewards are shared by *Sukuk* holders [details are in *Sukuk* chapter].

14. *Musharakah* and *Mudarabah* are the sources of financing available to Islamic banking which can play the role of catalyst in the uplifting living standard of unserved/underserved large population in underdeveloped countries including Muslim countries by providing opportunities for self-employment. *Mudarabah* financing can replace venture financing and could be used successfully in the promotion of new ideas generated by skilful graduates, lacking finances.

1.5. DIFFERENCES AND SIMILARITIES

In this section, I have analyzed the operations and products of IFIs in comparison with traditional conventional banks. Islamic finance is supposed to meet the same requirements of the business world as are being fulfilled by the conventional finance industry, in order to capture and sustain market share. Islamic finance is primarily designed for meeting the requirements of a large Muslim population scattered around the globe, although it is not limited to them. Islamic finance was developed as a reaction to a few questionable practices, according to the religion of Islam, in the conventional finance industry, including *ribā*, *gharar*, *maisir*, *qimar*, etc. Given the competition with the conventional finance industry, Islamic financial institutions (IFIs) offer competitive prices of their services, including financing, globally. So as far return to depositors and/or charge to users of funds are concerned is almost equal in both streams of banking. In fact, IFIs are price taker—and not price-setters—in the global financial market due to the very small size of the industry. Hence if we compare Islamic finance with conventional finance based upon the outcome [returns] of the transactions, we may conclude that there is no meaningful difference between Islamic and conventional finance. This is the reason for widespread misperception about Islamic finance even in Muslim societies.

1.5.1. Islamic Finance Contracts

Profit charging in a business transaction is more of a business decision than *Shari'ah*. According to *Shari'ah*, fair play is required, and no specific rate of profit is settled. It is the process of transactions through financial contracts which differentiate Islamic finance from conventional finance. Islamic finance instruments—in practice—used by the industry can be categorized objectively as trade-based, rental-based and profit and loss sharing.

Trading Contracts: Trading contracts [*Murabaha*, *Salam*, *Muajjal*, *Istisna'a*] are asset-based financing contracts, and usually, profit rate charged by IFIs is competitive with the broader financial industry. Although in asset-based financing contracts profit rate charged by IFIs are comparable with conventional loans; however, nature and risk attached to the contracts are entirely different from conventional finance. Under conventional finance, the only risk is default risk, while under Islamic finance bank has to bear certain other risks including price, technology, transportation, security, exchange-rate, in addition to credit risk.

Rental Contracts: The second mode of financing used by IFIs is *Ijarah* (rental based). According to the contract, the bank purchases an asset and lease to the customer for a specific period for a particular rental amount. At the completion of the term, usually, the asset is handed over to the customer either free of cost or for a specific sum of amount. During the tenure of *Ijarah*, the asset remains in the ownership of the bank and risk/reward of ownership is borne by the bank. The total charge to the customer remains the same and competitive with the conventional finance industry, however again under conventional finance the risk of the financier is only defaulting risk, while an IFI has to bear

certain other risks including theft, accident, repair and maintenance, technology changes, foreign exchange risk and disposal of asset etc. in addition to credit risk.

Profit & Loss Sharing Contracts: The third type of contracts, used by the Islamic finance industry, is based upon the principles of *Musharakah* (partnership). According to Islamic law, any profit-sharing ratio can be agreed among the partners with the only exception that share of sleeping partner cannot be in excess of his equity stake; however, loss-sharing is restricted to the amount of equity stake by each partner. Partnership contracts are two types; including *Musharakah* and *Mudarabah*. *Musharakah* is a kind of partnership where capital is contributed by all partners and management is either performed by all or any/few of them. In the case of *Mudarabah* partnership, one or more of the partners are without the capital contribution and act as manager of the business. Profit under *Mudarabah* is shared by the partners as per agreed ratio, while total loss is borne by the capital provider(s).

1.5.2. Principles of Financing

Based on objectives of *Shari'ah* following principles of Islamic finance have been documented by scholars.

Avoid Riba: First is the prohibition of interest and usury in financial dealings. The implication of this principle of Islamic finance is a discouraging time value of money in its conventional banking sense. Under the Islamic financial system, money is merely a medium of exchange and not a factor of production independently. Human labour is required in addition to cash to earn a return; hence there is no fixed return for capital; however, the capitalist can participate in business under profit and loss sharing with or without participation in the management of an entity.

Avoid Gharar: The second principle of Islamic finance is the avoidance of *Gharar* (uncertainty) in a business transaction. Ayub, (2007) defines "Gharar refers to entering into a contract in absolute risk or uncertainty about the ultimate result of the contract and the nature and/or quality and specifications of the subject matter or the rights and obligations of the parties [p. 75]. Mansoori, (2007), document that *Gharar* contains [specific] characteristics such as risk, hazard, speculation, uncertain outcome, and unknown future benefits.

Avoid Maisir: The third principle of Islamic finance is the avoidance of *Maisir* (speculation) or any game of chance (Ghazi, 2010). Ayub, (2007), document that *Maisir* refers to easily available wealth or acquisition of wealth by chance, whether or not it deprives the other's right. *Qimar* (similar to *Maisir*) means the game of chance; one gains at the cost of other(s) right [p. 62]. *Maisir* is prohibited by Holy Qur'an [2: 219 and 5: 90] as well as in *Hadiths* (Khan 1989, p. 92)

Profit & Loss Sharing: The fourth principle is profit and loss sharing. According to this principle capitalist demanding profit on capital should also participate in the loss as well (Khan 1989, p. 71; Usmani, 2002, p. 87; Ghazi, 2010, p. 386; Khan, 2007, p. 307 & Shari'a standard 12). According to this principle, an investor can earn a return on his investment subject to the risk of loss; hence the concept of risk-free return is disappeared under the Islamic financial system.

Halal Promotion: The fifth principle of Islamic finance is financing for only *Halal* (permitted) businesses. According to Qaradhawi, (1960) "Nothing is *Haram* except what is prohibited by a sound and explicit Nas [Verse of Qur'an and an authentic Sunnah] from the law-Giver Allah SWT". Ulema (scholars) have made the list of prohibited businesses in which investment for Muslims (Islamic

banks) is prohibited. Activities such as liquor, pork, pornography, adultery, dance clubs, conventional banking, insurance etc. are unlawful, hence earning a return through investment in any of these activities is not allowed under Islamic financial system.

To conclude, the Islamic financial system ensures justice between savers and investors. By demolishing risk-free return and promotion of profit and loss sharing, justice is provided for both parties, i.e. capital supplier as well as the capital user. As a model of modern commercial banking, initially, capital is supplied by depositors and later on by the bank to the business community. Under the Islamic financial system, the bank can invest in businesses to earn a variable return based on actual results of activities and share the profit earned with depositors based on the agreed sharing formula. Hence it is ensured to distribute the actual outcome, and none is to bear risk alone, and none is to earn with zero risks.

1.5.3. Functions of Banking

Islamic Financial Institutions (IFIs) operate in the same society where conventional banks do and perform all those functions which are expected from a financial institution. IFIs assist the business world by providing all the services required to run the economy smoothly; however, the philosophy and operations are different. Any financial system is expected to assist in running the economy by providing the following services grouped in two headings.

First, Savings mobilization from savers to entrepreneurs; and Second, Provision of general utility services including transfer of funds, facilitation in international trades, consultancy services, safekeeping of valuables, and any other service for a fee. There is no restriction on the provision of such services by IFIs except the service is against *Shari'ah*. However, there exists a difference in the mechanism of funds mobilization from savers to entrepreneurs as described following. Savings mobilization consists of two phases, i.e. accepting deposits and extending financing and investments. *Deposits Collection: Deposits* are collected from savers under both types of institutions for reward irrespective a bank is operating under the conventional system or Islamic system. The difference lies in agreement of reward. Under the conventional system, the reward is fixed and predetermined while under Islamic, deposits are accepted through *Musharakah & Mudarabah*—where the reward is variable. Under conventional banking, the return is higher on long-term deposits and lower for short-term deposits. Same is the practice in Islamic banking to share profit with depositors. Higher weightage for profit sharing is assigned to long-term deposits being available to the bank for investing in longer-term projects yielding superior returns and lower weightage for short-term deposits which cannot be invested in long term projects. The only difference in conventional and Islamic system lies in the sharing of risk and reward. Under the conventional system, total risk is borne by the bank, and total reward belongs to it after servicing the depositors at a fixed rate while under Islamic system risk and reward both are shared with depositors. The reward of depositors is linked with outcomes of investments made by IFIs. Under the Islamic financial system, only those IFIs will be able to collect deposits which can establish trust in the eyes of masses hence leading to optimal performance by the financial industry.

The second phase in savings mobilization process is the extension of credit facility to business and industry for return. Both types of institutions (Islamic and Conventional) are providing financing to productive channels for the reward. The difference lies in financing agreements. Conventional banks

offer loan for a fixed reward, while IFIs cannot do that because they cannot charge interest. IFIs can charge profit on investments but not interest on loans. In conventional banking, three types of loans are issued to clients, including short term loans, overdrafts and long-term loans. Islamic banks cannot issue loans except interest-free loans (*qard e hasan*) for any requirement however they can do business by providing the required asset to the client and/or participating in the outcome of the underlying project. In the following paragraphs, the comparative working of different products (financing scheme) of both systems is presented.

Overdrafts/Credit Cards: Conventional banks offer the facility of overdrawing from the account of the customer on interest. One of its forms is the use of a credit card whereby the limit of overdrawing for the customer is set by the bank. The credit card provides dual facility to customers, including financing as well as the facility of plastic money whereby the customer can meet his requirements without carrying cash. As far facility of financing is concerned, that is not offered by Islamic banks except in the form of *Murabaha* (which means IFI shall deliver the desired commodity and not the cash). However, the facility to shop/meet requirements is provided through debit card whereby a customer can use his card if his account carries sufficient balance. Under conventional banking, a customer is charged with interest once the facility availed; however, under *Murabaha*, only profit is due when the commodity is delivered to the customer. Furthermore, in case of default customer is charged with further interest for the extra period under the conventional system; however, additional charging is not allowed under *Murabaha*. Besides, under the conventional system, customer can avail the opportunity of rescheduling by entering into a new agreement to pay interest for an extended period which is not the case under *Murabaha*. IFIs can claim only the original receivable amount agreed in the initial contract. Another practical issue under *Murabaha* is how to deal with intentional defaulters. Different options are lying with IFIs including to blacklist the defaulter for any further financing facility, to stipulate in the contract that in case of default all instalments will be due at once, to specify in the contract a penalty shall be imposed but the same shall not form income of IFIs instead it will go in charity (Usmani, 2002).

Short term loans: Short- and medium-term loans are provided to customers to meet the working capital requirements of firms by conventional banks. Working capital is required by firms to invest in inventories and accounts receivables and meet the expenses. As far, inventory investment is concerned that is provided by Islamic banks through *Murabaha*. As far meeting of the day to day expenses of the business is concerned, financing is provided through participation term certificates whereby IFIs share the profit of a certain period (e.g. a quarter, six-month, one year) on pro-rata basis. However, financing through participation term certificates is not as easy as a short-term loan from conventional banks due to risk involved for IFIs in the transaction. Firm seeking short-term facility from IFIs has to prove the viability of the project/business to the satisfaction of investor.

For meeting the cash working capital requirements of nonprofit organizations to date, there is no arrangement under the Islamic financial system. Personal consumption loans in cash are also not issued by IFIs however, any individual of sound financial position can acquire anything for his personal use under *Murabaha* financing. *Murabaha* financing is very useful for short to medium-term financial requirements of business/nonprofit organizations and individuals. *Murabaha* financing is asset-based financing, and anyone can request to an IFI for provision of an asset generally used for

Halal (lawful) purposes. By default, under Islamic financial system, IFIs cannot lend cash for interest (the only exception is *qard e hasan*—interest-free loan).

Under the *Murabaha* scheme of financing, the facility is linked with assets which lead to economic stability and creates a linkage between the real and financial sectors. It is not a zero-sum game because the utility is created through services and products and not by mere building the blocks of wealth through dealing in paper money.

Although *Murabaha* is being used by IFIs successfully and have succeeded in meeting the short-to-medium term requirements of firms by providing a successful replacement of conventional loans, yet specific differences exist in both types of financing. First, one cannot get cash from the bank under *Murabaha*. The second, the asset is purchased by IFI initially then transferred to customer hence IFI participate in risk. Third refinancing facility is not available under *Murabaha*. Fourth in case of default price of the commodity cannot be enhanced; however penalty may be imposed if stipulated in the original contract of *Murabaha*; however, same cannot be included in the income of IFI. Fifth only those assets can be supplied by IFIs under *Murabaha* whose general and/or intended use is not against the injunctions of *Shari'ah* (e.g. supply of a machine to produce liquor is prohibited).

Medium to long term loans: Medium to long-term loans are provided for purchase or building of fixed assets by firms to expand or replace the existing assets. Under the Islamic financial system, the requirements of firms and individuals can be fulfilled through *Murabaha*, *Bai Muajjal* and *Istisna'a*. Another financing option for long-term financing is profit & loss sharing under *Musharakah* and *Mudarabah*. Although financing under *Murabaha*, *Bai Muajjal* and *Istisna'a* are very much look like conventional loans with the only difference of provision of asset and not cash to clients however differences exist in the contracts which alter the nature of risks and returns. Financing under *Musharakah* and *Mudarabah* is challenging for IFIs and firms as well. Under *Shari'ah* based financing schemes firms have to prove the viability/profitability of the project/business to the satisfaction of IFIs to get the finance because the risk of losing the amount is involved.

Leasing: Leasing is relatively a recent source of financing whereby usufruct of an asset is transferred to the lessee for agreed amounts of rentals. Under leasing, ownership may or may not be transferred. The same facility is provided by IFIs under an agreement of *Ijarah*. Under *Ijarah* asset is delivered to the customer for use without transfer of ownership for a specific period in exchange for agreed rentals. Ownership of asset can be transferred to the customer through mutual agreement at the completion of the lease term. All ownership risks are borne by IFIs during *Ijarah* tenure. Specific differences exist in the transaction under both systems. First is rental under *Ijarah* are not due until the asset is delivered to the lessee for use. Second, additional rent cannot be demanded in case of default except a penalty (if stipulated in the original contract of the

Differences Between Conventional & Islamic Finance

1. Financing for Halal businesses only
2. Equity based financing: Profit as well as loss sharing under Partnership
3. Asset based Financing: Dealing in goods and service
4. Avoidance of Gharar [uncertainty], Maisir and Qimar [game of chance]
5. Interest free operations
6. On deposits no risk free return
7. Shari'ah compliance by investee is must to invest in shares
8. Asset based Sukuk carrying profit and loss sharing
9. Leasing through rental contract
10. House financing is combination of leasing and partnership

lease) which is not the income of IFI. Third, during the period of significant repair, rent cannot be demanded by IFI. Fourth, if the asset is lost or destroyed, IFI cannot claim further instalments hence all risks of ownership are borne by IFI.

Agricultural Loans: Agricultural loans include both types of loans short-term as well as long-term. Farmers require short-term loans for seeds and fertilizers, and long-term loans are needed to develop additional lands and purchase of equipment. Typically, farmers return these loans after selling the finished crops. Conventional banks provide credit facility by charging interest. IFIs have the options to serve the farmers through *Bai Salam*, *Bai Murabaha* *Musharakah* and *Mudarabah*. *Bai Salam* is a form of sale contract whereby IFIs purchase goods for spot payment with delayed delivery. Practically it is used in the financing of agricultural needs of farmers. Farmers sell their crops before harvesting to IFIs in order to get money to purchase seeds and fertilizers, etc. For purchase of equipment, *Murabaha* facility is used, and for development of additional land, *Musharakah* and *Mudarabah* may be used by IFIs. To get finance for land development, farmers have to convince the IFI about the profitability of the venture due to the risk involved in the transaction.

House financing: Housing finance/Mortgages is the more secured form of financing for both conventional banks as well as IFIs. Under the conventional system, a loan is provided for interest while under Islamic financial system, the facility is provided through diminishing *Musharakah*. Under diminishing *Musharakah* house is purchased jointly by IFI and customer. IFI rents out its share in the property to the customer for an agreed amount of rent. Share of the financier is divided into units of small denomination. Customer pays the instalments to IFI consisting of rentals plus the purchase price of a unit. The stake of the customer in property is increasing while of IFI is decreasing with the payment of every instalment. Finally, with the payment of last instalment stake of IFI reaches zero and ownership is transferred in the name of the customer. Diminishing *Musharakah* model can help out in avoiding the real estate crisis (like of 2008) because when the market value of the property decreases both IFI and customer suffer according to their share in the property and the whole burden is not shifted on customer alone. Literature has raised specific questions about the existing practice of IFIs, which needs to be addressed by policymakers, *Shari'ah* boards and management of IFIs.

Investments: In order to maintain liquidity, conventional banks have many avenues including government securities, short term loans and money at call and short notices, leasing companies' bonds, investment in shares etc. Interestingly mandatory reserve maintenance by conventional banks (a portion with central banks and another portion invested in government securities) is also rewarded in the form of interest. Conventional banks can also create liquidity by issuing bonds against their receivables. Conventional banks are also protected by central banks by providing liquidity in rainy days for interest. Interbank deposits are also rewarded in the form of interest by commercial banks.

For IFIs, avenues are limited to create necessary liquidity at the same time to earn some revenue by investing in the short term and liquid securities. IFIs cannot invest in government securities, short term loans, bonds and money at call and short notices because of interest-based transactions. Mandatory reserve with central banks is maintained by IFIs, but they are not rewarded like conventional banks. Looking towards central banks in rainy days to maintain liquidity is also not as straightforward due to interest demand of central bank. IFIs cannot demand interest on interbank deposits. As far investment in marketable securities are concerned, again IFIs are not free to invest

in any equity security due to two reasons. First, *Halal* business of the underlying firm is required. Second, the financial operations of the underlying firm should be interest-free, ideally. Keeping in view the dominance of conventional banking and existing business practices, one can conclude safely that a very negligible number of firms meet both conditions. The much appreciable job has been done through the creation of Islamic Indexes worldwide. Although differences exist within different indexes' in *Shari'ah* compliance filters which needs the attention of experts. IFIs can invest only in those securities which are declared *Shari'ah* compliant through filtering by *Shari'ah* compliance criteria. Over the period, IFIs have created an avenue to meet their liquidity requirements in the form of *Sukuk* (Islamic Bonds) whereby servicing is fixed like conventional bonds, relatively, in some types of *Sukuk* (like *Ijarah*). The underlying principle in the issue of *Sukuk* is that illiquid assets (real assets) should dominate in the portfolio against which *Sukuk* are issued. Under the Islamic financial system, *Sukuk* are ownership certificates and not mere debt securities hence all risks and rewards are shared by *Sukuk* holders.

To conclude this section, Islamic financing is working within the *Shari'a* framework following certain restrictions. Islamic banking is not as foreign to the business world as it is perceived by certain quarters. It is a business very much like conventional banking within certain restrictions imposed by Islamic law. IFIs are fulfilling all business needs in efficient ways through *Murabaha*, *Ijarah*, *Bai Muajjal*, *Bai Salam*, *Istisna'a*, *Musharakah* and *Mudarabah*. Two features of Islamic financial system are worth mentioning. First is the linkage between financial and real sectors as IFIs cannot extend credit facility without having support from the real industry. Financing is either made through sharing risk and reward or must be asset-backed. Second, a unique feature of the Islamic financial system is in the form of *Mudarabah* which can play the role of catalyst for transforming society into prosperity by extending the financing facility to skillful persons lacking capital. Under *Mudarabah* mode of financing partnership between capital and skill is formed; hence it can be used to provide self-employment to jobless skilled citizens.

Islamic banking is not a mere copy of conventional banks as perceived by certain Muslims. It has its own way of doing business, and all operations are duly certified by *Shari'ah* experts ranging from *Shari'ah* advisors to *Shari'ah* boards and finally international bodies like IFA and AAOIFI. Islamic banks do business in a nonconductive environment which makes operations challenging. IFIs cannot claim interest on their balances with other banks; on mandatory cash reserve maintained with the central bank; cannot invest in government securities; interest-based bonds; cannot claim time value of money from defaulters; bear risks in sale and lease transactions; can only invest in *Shari'ah* compliant securities and not in all available equities; and finally have to compete with conventional banks in deposit servicing as well as in financing. Despite these difficulties, double-digit growth in assets under Islamic financial system world over is impressive and suggests a bright and promising future for this financing system. It does not mean everything is perfect, and there are specific challenges to the industry, discussed in another section of the chapter.

1.6. CHALLENGES TO ISLAMIC FINANCIAL SYSTEM

With the advent of modern Islamic banking and speedy growth through the application of business skills, well versed in business but lacking in relevant knowledge of Islamic finance, specific questions on practices are raised by various quarters. It is pertinent to document the objections/issues raised by experts as well as masses. Addressing the market concerns is a challenge for the industry. Here is a list of challenges for Islamic financial system:

Market Perceptions: A very serious challenge for the Islamic financial system is to address the perception-issues of the market. There is a reasonable number of experts who think Islamic banking cannot meet the total needs of the industry. At the same time, there is a large number of masses who think Islamic banking is a mere change of name, and there is no difference in conventional and Islamic banking. IFIs need to address the issue by increased Islamic finance literacy, as well as, through making improvements in prevailing business models.

Inflation Indexation: A question is raised by some quarters about the reduction in purchasing power of the paper currency. It is said that by the time of revelation, paper currency was not in circulation; hence injunctions about coins cannot be implemented on paper currency. The most critical issue is the devaluation of paper currency due to inflation. Indeed, one loses his wealth due to inflation if kept in currency. Equally; wealth is lost if given as *qard e hasan* (charity loan) giving zero return; slightly negative return if currency devalued due to inflation. It is a very valid argument, and I analyze it in two parts.

- First is the issue of excessive inflation which we face in less developed countries, including some Muslim societies, is not the direct consequence of paper currency instead it is financial indiscipline of the governments of these countries. After all, why such a massive figure of inflation is not hitting the developed world. Discipline is required in government spending, borrowings and issue of currency.
- Second, as far mild inflation is concerned that requires debate and settlement. The case for indexation of loans as per actual inflation in the economy is being debated at various forums among the *Shari'ah* scholars and we expect an early outcome⁹.

Similarity in Products: Another question is asked about the similarity in products and even charges by IFIs in line with conventional banking practices. Undoubtedly IFIs are trying knowingly and willfully to match in products, services, costs and returns with conventional banks. This phenomenon exists due to:

- IFIs lack severely the skilled human resources qualified in Islamic finance with due understanding of the philosophy of Islamic financial system
- The dominance of conventional banking with significant market share even in Muslim societies

⁹ [For details on the topic of indexation please see "Indexation of loans by Mohay ud Din Hashmi" chapter in book "Institutions of collective Juristic opinions, Concept, Evolution and Practical ways" [Ijtamai Ijtihad kay idarey; tasawer , Irtaqa aor amaly tareekay; in Urdu language], Institute of Islamic Research, International Islamic University, Islamabad, Pakistan.]

- Conventional banks are immediate competitors of IFIs hence an element of fear of losing customers is always there.

Pricing of Products: Fourth is a linkage of profit percentage charged by IFIs on their products with the interbank offered rate (KIBOR, LIBOR, etc.). Indeed, this is not appreciable that an institution claiming itself *Shari'ah* compliant in its operations use the benchmark of interest for charging profit, however, using IBOR as a benchmark does not translate the transaction itself *Haram* [unlawful] (Usmani, 2003). Why do IFIs use IBOR as a benchmark? The possible reasons include:

- IFIs are competing with conventional banks hence trying to be competitive in the market; and
- lack of any other benchmark based on *Shari'ah* compliant tools

One can hope with the increase in market share, IFIs would be able to develop their own benchmark for profit.

Late Payment Charges: Another question relates to charging of cash penalty in case of default by the customer at the due date. Although cash penalty is not the only solution to handle the problem of default, however, it is allowed by scholars due to poor governance and delayed provision of justice. If speedy justice can be provided then no need to impose a penalty on defaulter, however, one must appreciate that financial penalty is not the interest like conventional banks charge as it goes into charity account and not in the pocket of banks.

Single Profit Rate: Islamic banks are dealer of goods, by design. Use of a single profit rate based upon IBOR is another challenge which industry faces. Ideally, market rates of each sector of the economy should be used by Islamic banks, but so far it is not achieved. At present, the same profit rate is charged for housing as well as an auto industry which delinks profits of IFIs from the market. Perhaps it is due to the following of footsteps of conventional banking.

Sectoral Deposits: IFIs have not created so far specialized deposit schemes including housing, *Ijarah*, and *Istisna'a*, which can differentiate industry from conventional banking. According to the scheme, it is suggested to create restricted *Mudarabah* investment accounts where investment by banks is restricted to a particular industry, and actual return is shared with depositors.

Cash Financing: Usually, businesses look at banks for immediate cash requirements. Under Islamic financing cash financing is not offered to meet day to day requirements of the industry; this is another challenge being faced by the industry to penetrate the market. The challenge can be addressed through the design of contracts based on *Istisna'a*, *Musharakah* and *Mudarabah*.

Ignorance of Market Value: IFIs transact some deals by using real assets, including house financing and *Sukuk*. Another challenge is to deal in market value terms for the repurchase of *Sukuk* and sale of banks' equity shares under diminishing *Musharakah*. At present, par value is used, which is more in line with conventional banking than Islamic.

Challenges for Islamic Finance

1. Use of IBOR as benchmark for profit
2. Use of par value in selling the shares of IFI in House financing
3. Use of par value in purchase of *Sukuk* at the time of redemption
4. Use of financial penalty in case of default by customer
5. Use of independent party guarantee of capital in case of *Sukuk*
6. Use of time value based computer software in calculation of installments
7. Very minor use of profit and loss sharing, *Salam* and *Istisna'a* modes of financing
8. Non availability of cash financing for day to day operations except through *Musharakah*

Application of Profit and Loss Sharing: Use of profit and loss sharing in financing is much lesser than debt creation modes of financing. The issue is the lack of trust, which is vital between IFI and customer to put sharing models into practice. *Musharakah & Mudarabah* can only work if the customer discloses his earnings honestly in a transparent way. This argument is also very valid and carries some empirical support as well. By looking at portfolios of IFIs, it is evident that sharing modes are not as much practised as others. We must accept this fact that trust deficit exists among customers and IFIs. However, we cannot conclude the impracticability of sharing modes of financing due to the following facts:

- Deposits are accepted by IFIs under sharing modes and succeeded in building trust in the eyes of depositors
- The corporate world is working under sharing modes. An investor who purchases the shares of a company becomes the limited partner of that company; hence, sharing modes of doing business are not foreign to the business world.

Standardization of Products: Another challenge is the establishment of central *Shari'ah* supervisory board which can guide industry globally. At present multiple Islamic indexes working globally, with different criteria of *Shari'ah* screening. Also, there are different versions of Islamic finance of Iran, Malaysia, Pakistan and other countries which demand the attention of policymakers to bring them on the same page.

Shari'ah Governance: *Shari'ah* governance of the Islamic finance industry is very vital for the success of the industry. Sound *Shari'ah* governance will contribute to trust and positive perception among the masses. At present *Shari'ah* compliance departments of IFIs are headed by *Shari'ah* scholars, but the critical question is “do they carry due knowledge and skill of modern business and finance? Understanding of *Shari'ah* as well as modern finance is essential to extract the right course of action. Sound *Shari'ah* governance of IFIs is must for credibility and survival of the industry. Composition of *Shari'ah* board, qualification of *Shari'ah* auditor, audit system and process, internal *Shari'ah* control system, etc. need to be standardized. A regulatory framework for Islamic Financial Services Industry (IFSI) is required to address the *Shari'ah* governance issue.

An investor who purchases the shares of a company becomes the limited partner of that company; hence, sharing modes of doing business are not totally foreign to business world.

Human Resources: Islamic finance assets are growing in double-digit over the years but the supply of human resources trained in Islamic finance is not matching with the demand. Qualified human resources play an essential role in make or break of any organisation, and Islamic financial institutions have no exception. Islamic financial industry suffers from a shortage of human resources. At present, most of the Islamic bankers have qualified from traditional business schools with an insignificant understanding of IFSI. They develop a product for marketing to customers and get certification from an Islamic scholar, i.e. *Shari'ah* advisor or *Shari'ah* board. Islamic scholars are trained in religious studies with minimal to zero courses in the areas of modern businesses, especially economics and finance. There is a knowledge gap between the two related groups (*Shari'ah* scholars and finance professionals). Literature documents evidence on the lack of expertise in financial education among *Shari'ah*-scholars; and lack of expertise in *Shari'ah* among professional-bankers. Hence, they are unable to understand the viewpoint of each other, indeed, in spite of all honest efforts. Hence, it is an important

need to design and offer higher education degrees in the areas of Islamic economics and business, covering courses from religion and liberal sciences. Individual efforts are in the process; however, unless we have bankers (Islamic bankers), the problem cannot be solved.

Regulatory Framework: The regulatory framework is required for the Islamic financial system in all jurisdictions to monitor and run the industry smoothly. Regulations of modern business institutions are vital for the achievement of objectives, and the Islamic financial industry has no exception. There are multiple countries engaged in the practice of Islamic finance; however, the regulatory framework is missing (a few exceptions maybe). Literature has raised the issues and needs for the regulatory framework for Islamic Financial System. Finally, in the absence of specific Islamic finance regulatory framework, how to address the conflict resolution aspect? Under existing corporate and banking laws, *Shari'ah* compliance is voluntary. Contracts are designed in conformity with *Shari'ah* laws; hence, enforcement of agreements requires a specific regulatory framework in light of Islamic finance principles.

1.7. ORGANIZATION OF BOOK

Rest of the book is organized as follows. Part two elaborate asset-backed financing provided by IFIs. It includes trading (selling) modes of financing including *Murabaha*, *Salam*, and *Istisna'a*; as well as rental based financing—*Ijarah*. At the start of part two, a summary of *Shari'ah* rulings about trading is presented. Chapter two is about *Murabaha* (cost-plus-profit sale) the most widely used financing tool by IFIs world over and *Muajjal* (deferred sale). *Murabaha* is a useful tool to replace overdraft and short-term financing. The chapter includes the basic rules of *Murabaha*, necessary steps involved and comparative study with conventional short-term loans including bank overdraft facility. Chapter three is about *Bai Salam*; a form of sale contract whereby IFIs purchase goods for spot payment with deferred delivery. It is a recommended financing product to finance agricultural needs of farmers. Chapter four is about *Istisna'a*. This mode of financing is designed to transact business through an order to manufacture and/or supply. It is a sales contract with the exception of the existence of subject matter. This tool of financing is useful for infrastructure projects. Chapter five is about *Ijarah*; a rental contract whereby IFI leases an asset for a specific rent and period to the client. *Ijarah* has proved its usefulness in replacing conventional lease financing.

Part three of the book deals with profit and loss sharing modes of financing including *Musharakah*, *diminishing Musharakah*, *Mudarabah* and deposit management. Chapter six is about *Musharakah* financing. *Musharakah* means a joint enterprise formed for conducting some business in which all partners share the profit according to pre-agreed ratio while the loss is shared according to the ratio of contribution. A special section is devoted to discuss the lesser application of *Musharakah* in operations of IFIs in addition to summary of *Shari'ah* rulings and illustration of financial impact. Chapter seven is about *diminishing Musharakah*; a form of gradually declining partnership between IFI and client, generally used to finance real estates. Under *diminishing Musharakah*, Islamic house financing, comparison with conventional mortgages, and installment calculation are elaborated. Chapter eight is about *Mudarabah*. *Mudarabah* is a type of partnership whereby skill and money brought together to conduct business. Profit is shared according to an agreement while the loss is borne by capital provider only. Under this scheme of financing, IFIs are expected to provide capital to financially weak but skillful people to do the business and share the outcome with IFIs. Chapter nine presents various types of deposits collected by IFIs and profit-sharing mechanism. Concepts of daily product and weightage-based profit allocation are elaborated.

Part four of the book presents special topics in Islamic finance. Chapter 10 and 11 devoted to liquidity management [capital market operations including equities and sukuk]. An update on developments in the area of capital market operations is provided in these chapters. Chapter 12 presents introduction to Islamic insurance (*takaful*). The topics include summary of *Shari'ah* rulings and insurance models including general and life insurance. Chapter 13 presents an evaluation of existing currency system in light of Islamic finance objectives. Chapter 14 highlights the issue of economic

substance and legal form. The last chapter identifies the challenges to the industry [potentially hinder the sustainability] and offer future courses of action to overcome the challenges.

At the last section of the book procedures and rules, as issued by the central bank (Pakistan), relating to the creation of an Islamic bank, independent Islamic banking branches by conventional banks and subsidiary of a conventional bank to transact business of Islamic banking are included as appendixes.

1.8. QUESTIONS

Essay Questions

1. What is meant by Islamic financing? Why there was a need to have a different than the conventional financial stream?
2. How did Islamic Islamic finance emerge over the decades? What is the present status of the industry?
3. What are injunctions about the prohibition of interest in the Bible and the Qur'an? Explain briefly?
4. Explain the business models of modern Islamic financial system.
5. What are the differences in conventional and Islamic banking?
6. What are the salient features of Islamic banking?
7. Address the objections raised by critics of Islamic banking.
8. What are the five most significant challenges for the Islamic financial system?

Multiple Choice Questions

1. Which of the following best describes the difference in Conventional and Islamic Banking?
 - a. Riba (Interest) is the only difference in conventional and Islamic banking.
 - b. Shari'ah compliance in all operations of banking by Islamic banks
 - c. There is no difference between Islamic and conventional banking
 - d. None of the above
2. Which of the following best describes term *Riba*, used in Holy Qur'an?
 - a. Additional charge on consumption loans (usury) is riba
 - b. Additional charge on productive loans (commercial interest) is riba
 - c. Any predetermined additional charge in a loan transaction irrespective of purpose is riba
 - d. None of the above
3. Under Islamic law, sources of law are four. Which of the following, priority wise is a correct order?
 - a. Ijma, Sunnah, Qur'an, and Ijtihad
 - b. Qur'an, Sunnah, Ijma and Ijtihad
 - c. Ijtihad, Ijma, Qura'n, and Sunnah
 - d. Sunnah, Qura'n, Ijma and Ijtihad
4. The last set of revealed Ayahs (Verses) about the prohibition of Riba is reported in which of following Surah (Chapter) of Holy Qura'n?
 - a. Surah Al-Rum
 - b. Surah An-Nisaa
 - c. Surah Al-i-'Imran
 - d. Surah Al-Baqarah
5. According to SESRIC, by the end of 2019, which of the following countries is the largest contributor to global volume of assets under Islamic banking industry?

- a. Saudi Arabia
 - b. The Islamic Republic of Iran
 - c. United Arab Emirates
 - d. Malaysia
6. According to SESRIC, by the end of 2019, which of the following regions is the largest contributor to global volume of assets under Islamic banking industry?
- a. South and Southeast Asia
 - b. Gulf region
 - c. European Union
 - d. North America
7. Five Khiyars (options) in a trading contract are salient features of Islamic commercial law. What is meant by Khiyar-e-Ghaban?
- a. Option to terminate contract by purchaser if goods lacking required quality
 - b. Option to terminate contract by purchaser if seller charges significant higher than market price through deceit
 - c. Option to rescind contract within a specified period
 - d. Option to return defective goods
8. The financial penalty is charged by both conventional as well as Islamic banks in case of delay in payment by the debtor. Which of the following correctly displays the difference?
- a. Both types of banks have to serve the depositors; hence, late payment charges are justified
 - b. Anybody who is a wilful defaulter should be penalized in the form of financial penalty
 - c. Charging of financial penalty to defaulter is not against Islamic law. However, the amount of penalty must not be used to compensate the creditor; rather, it should be spent on charity.
 - d. When a debtor defaults, it put the financial institution in hardship; hence, time value of money should be recovered from defaulter.
9. To invest in the equity of a company by an Islamic bank, *Shari'ah* compliance of investee is required. One of the *Shari'ah* compliance tests is a debt to total assets ratio. Which of the following is the maximum limit, as per AAOIFI screening criteria?
- a. Debt/Total Asset <40%
 - b. Debt/Total Asset <30%
 - c. Debt/Total Asset <20%
 - d. Debt/Total Asset <10%
10. According to GIFR (2019), during last nine years (2010-18) Islamic financial services industry has grown, approximately, at an average annual growth rate of
- a. 8 percent
 - b. 16 percent
 - c. 18 percent
 - d. None of the above
11. Asool e Din (principles of Islamic religion) include:
- a. Tauwheed (oneness of Allah)
 - b. Risalah (prophet-hood)
 - c. Akhira (day of judgement)

- d. All of the above
12. Objectives of Shari'ah include:
- a. Protection of faith (*Hifz e Eimaan*)
 - b. Protection of life (*Hifz e Nafs*)
 - c. Protection of wealth (*Hifz e Maal*)
 - d. All of the above
13. Objectives of Shari'ah include:
- a. Protection of intellect (*Hifz e Aqal*)
 - b. Protection of lineage (*Hifz e Nasal*)
 - c. Protection of wealth (*Hifz e Maal*)
 - d. All of the above
14. According to capitalism, factors of production include:
- a. Land & capital
 - b. Labour & land
 - c. Capital & Organisation
 - d. All of the above
15. According to capitalism, rewards for factors of production are fixed, except:
- a. Land & capital
 - b. Labour & land
 - c. Capital & Organisation
 - d. Organisation
16. Under Islamic financial system and capitalism, which of the factors of production receive variable return:
- a. Land & capital
 - b. Labour & land
 - c. Capital & Organisation
 - d. Organisation
17. Unlike capitalism, reward for a factor of production is variable under Islamic financial system:
- a. Land & capital
 - b. Labour & land
 - c. Capital & Organisation
 - d. Capital
18. Unlike capitalism, reward for a factor of production is variable under Islamic financial system:
- a.** Land & capital
 - b.** Labour & land
 - c. Capital & Organisation
 - d.** Capital
19. *Riba* [usury & commercial interest] is *Haram* (prohibited) undoubtedly because we find the evidence in:
- a. *Qur'an*
 - b. *Sunnah*
 - c. *Ijma'a*
 - d. All of the above

20. Islamic finance (led by religion) is a reaction to certain questionable practices in the conventional financial system including:
- Riba* [interest & usury]
 - Gharar* [excessive risk]
 - Maisir and Qimar* [speculation and game of chance]
 - All of the above
21. Islamic finance is expected to:
- Refrain from financing the Haram [prohibited] segments of the business
 - Promote social values including social justice
 - Contribute to equitable distribution of wealth
 - All of the above
22. Islamic banks use financing tools being used in the trade including:
- Murabaha* (cost plus profit)
 - Ijarah* (rental arrangement)
 - Bai-Salam* (spot payment with delayed delivery of goods)
 - All of the above
23. Islamic banks use financing tools being used in the trade including:
- Bai-Salam* (spot payment with delayed delivery of goods)
 - Istisna'a* (order to manufacture/supply)
 - Diminishing *Musharakah* (for house financing)
 - All of the above
24. If funding is required in cash form, then Islamic banks are expected to use profit and loss sharing modes, including:
- Musharakah* (partnership in the capital)
 - Mudarabah* (partnership in money and skill)
 - Musharakah & Mudarabah*
 - None of the above
25. In the Indian subcontinent, scholar(s) _____ declared dealing in banking interest illegitimate for Muslims and voiced for an economic system as per Islamic teachings before the 1950s:
- Iqbal
 - Maudoodi
 - Iqbal and Maudoodi
 - Al-Sadr and Qutb
26. In the Arabian region, scholar(s) _____ declared dealing in banking interest illegitimate for Muslims and voiced for an economic system as per Islamic teachings before the 1950s:
- Iqbal
 - Maudoodi
 - Iqbal and Maudoodi
 - Al-Sadr and Qutb
27. Beginning from the period of liberation from colonial powers, specific notable reform movements towards Islamisation started in Muslim societies, including:
- Pakistan
 - Iran

- c. Sudan
 - d. All of the above
28. According to capitalism, rewards for factors of production cannot be negative, except:
- a. Land & capital
 - b. Labour & land
 - c. Capital & Organisation
 - d. Organisation
29. In _____ specific efforts by the governments of respective countries have made to transform the economy as per the Islamic financial system:
- a. Pakistan & Iran
 - b. Iran & Sudan
 - c. Sudan & Pakistan
 - d. All of the above
30. The milestone in the development and implementation of Islamic financial system was the conference of Finance Ministers of Organization of Islamic Conference (OIC), December 1973, in Jeddah, whereby the decision to establish _____ was taken place.
- a. Islamic Development Bank
 - b. Islamic Financial Services Board
 - c. International Islamic Financial Market
 - d. Islamic Fiqh Academy
31. In 1980 first-ever landmark report on “Elimination of *riba* from the Economy” came on the surface, written by Council of Islamic Ideology [CII]:
- a. Pakistan
 - b. Iran
 - c. Sudan
 - d. Malaysia
32. In 1991 _____ was established with the mission to standardize and harmonize Islamic finance practice and financial reporting following Islamic law, globally.
- a. Islamic Development Bank
 - b. Islamic Financial Services Board
 - c. International Islamic Financial Market
 - d. Accounting & Auditing Organization for Islamic Financial Institutions [AAOIFI]
33. _____ was established in 2002 in Bahrain with a vision to pursue well-regulated trading of *Shari’ah* compliant financial instruments.
- a. Islamic Development Bank
 - b. Islamic Financial Services Board
 - c. International Islamic Financial Market
 - d. Accounting & Auditing Organization for Islamic Financial Institutions [AAOIFI]
34. _____ issues professional standards on capital adequacy, corporate governance and risk management for the smooth running of the industry in light of *Shari’ah* principles.
- a. Islamic Development Bank
 - b. Islamic Financial Services Board
 - c. International Islamic Financial Market
 - d. Accounting & Auditing Organization for Islamic Financial Institutions [AAOIFI]

35. _____ was established under auspices of OIC in 1983 with the objective to offer Islamic solution to challenges of modern life by consolidated efforts of Muslim intellectuals.

- a. Islamic Development Bank
- b. Islamic Financial Services Board
- c. International Islamic Financial Market
- d. Islamic Fiqh Academy

Assignment

Select ten companies of your choice and determine *Shari'ah* compliance status by applying the *Shari'ah* filtering criteria discussed in the chapter.

Suggested Readings

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Appendix—Chapter 1

Table-A. Islamic Banking statistics in Gulf region [2019]

Indicator	Kuwait	Bahrain	Saudi Arabia	Qatar	UAE	Oman	GCC	Iran	Gulf Region
ATMs	747	213	8,212	419	1,885	32	11,508	59,519	71,027
Employees	-	2,034	17,742	2,282	8,209	1,376	31,643	222,397	254,040
IB Branches	177	63	828	75	271	84	1,498	20,598	22,096
I. Banks	6	20	12	4	8	8	58	34	92
Assets US\$ B	112	-	439	361	154	12	1,078	504	1,582
Fin-\$ B	74	-	120	248	99	7	549	294	842

Data Source: SESRIC

Table-B. Islamic Banking statistics in South & Southeast Asia [2019]

Indicator	Indonesia	Brunei	Malaysia	Bangladesh	Pakistan	Total S&SA
ATMs	2,805	144	-	1,309	1,595	5,853
Number of Employees	55,178	1,139	119,906	34,273	28,222	238,718
Islamic Banking Branches	637	27	4,416	1,245	3,154	9,479
Number of Islamic Banks	34	2	26	23	22	107
Total Assets US\$ B	35	8	196	37	19	294
Total Financing US\$ B	27	2	146	28	13	216

Data Source: SESRIC

Table-C. Financing Modes in portfolios of global Islamic Banking Industry (2018)

Description	Southeast	South Asia	GCC	MENA-ex GCC & Iran	Iran	UK	percent
Number of Countries	03	04	06	08	01	01	23
Number of Islamic Banks**	32	16	45	59	34	5	191
Number of Domestic Branches	2,750	2,818	1,456	2,354	20,598	17	29,993
Murābahah	33.5%	55.0%	33.8%	63.7%	19.0%	6.6%	29.91%
Commodity Murābahah/ Tawwaruq	0.0%	0.6%	12.9%	3.0%	12.4%	43.2%	9.54%
Salam	0.0%	1.4%	10.6%	0.4%	1.0%	0.0%	4.54%
Istisnā`	0.3%	2.7%	0.0%	6.1%	0.0%	0.0%	0.27%
Ijārah / Ijārah Muntahia Bittamlik	10.8%	19.7%	8.9%	18.5%	0.0%	9.2%	6.87%
Muḍārabah	0.2%	1.7%	0.0%	1.7%	2.5%	0.0%	0.99%
Mushārahah	9.0%	4.8%	0.2%	1.4%	50.8%	0.0%	19.31%
Diminishing Mushārahah	0.6%	5.0%	0.1%	0.3%	0.0%	34.3%	0.54%
Wakālah	0.0%	0.0%	0.2%	0.6%	0.0%	1.2%	0.09%
Qarḍ Hassan	0.0%	1.3%	0.0%	0.7%	8.3%	0.0%	2.87%
Others	45.7%	7.9%	33.3%	3.5%	5.9%	5.5%	25.07%

Data source: Islamic Financial Services Board, Prudential and Structural Islamic Financial Indicators (PSIFIs) for Islamic Banks; Data is not available for Brunei, Qatar, Bahrain, Turkey, Lebanon, Egypt, and Libya; [Southeast Asia includes Brunei, Indonesia, and Malaysia]; [South Asia includes Bangladesh, Pakistan, Afghanistan, and Kazakhstan]; [GCC includes Kuwait, Bahrain, Qatar, UAE, Oman and KSA]; [MENA includes Turkey, Lebanon, Jordan, Palestine, Egypt, Sudan, Libya, and Nigeria].