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INDUSTRIAL FINANCING TECHNIQUES OF ISLAMIC BANKS*

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The guidance for all institutional arrangements in an Islamic society is to be derived from the principles of Shariah. The form and content of Islamic banking practices have therefore to be deduced from the teachings of Islam. There was no prototype of modern banks in the early history of Islam. Even in the Western countries banking in the form in which it exists today is comparatively of recent origin. The attitude of Islam to all known innovations is that nothing should stand in the way of their adoption if they are useful for human society and do not conflict with the fundamental principles as enunciated in the Holy Qur'an and Sunnah. Banks perform a useful role of financial intermediation between savers and investors. They pool small amounts of individual savings into large funds and make it possible for entrepreneurs to undertake small, medium and large projects through finance provided by them with the help of peoples' savings. Since savings can perform a useful purpose for the soceity only if they are invested and all savers cannot be expected to possess the skill necessary for productive investment, there is no reason to doubt that banks as an institution can exist in an Islamic society. However, as far as the conduct of actual banking business is concerned, banks in an Islamic society cannot be patterned on the Western model as it has features repugnant to Islam.

The Western banking system is primarily based on interest. The giving and taking of interest is strictly prohibited in Islam. Abstinence from interest is enjoined by the verses in the Holy Qur'an as well as the authentic sayings of the Holy Prophet (Peace be upon him)

The Arabic word used is riba and there is a consensus among Muslim scholars that interest in all forms and manifestations comes within the meaning of the word riba. Transactions based on interest are severely condemned in the Holy Qur'an and Sunnah. The Qur'an says:

> "Those who swallow 'riba' cannot rise up save as he ariseth whom the devil has prostrated by (his) touch. That is, because they say: Trade is just like 'riba'; whereas Allah permitteth trading and forbiddeth 'riba'. He unto whom an admonition from his Lord cometh, and (he)refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affairs (henceforth) is with Allah. As for him who returneth to 'riba', such are rightful owners of the Fire. They will abide therein. Allah hath blighteth 'riba' and made 'sadaqat' fruitful. Allah loveth not the impious and guilty". [2:275-276]

There is another verse in the Holy Qur'an on the subject of riba which says:

> "O ye who believe! Devour not 'riba', doubling and quadrupling (the sum lent). Observe your duty to Allah that ye may be successful". [3:130]

The above verse has been cited by some to argue that it is compound interest (doubling and quadrupling) which is prohibited in Islam and not simple interest. This is a grave misunderstanding. The above verse just refers to a practice which exists in some loan transactions in which interest accumulates quickly, doubling and quadrupling the sum lent. It does not approve of the taking of interest if the rate of interest is not that high. The fact that Islam prohibits not only compound interest but all types of interest is borne out by the following verse in the Holy Qur'an:

> "O ye who believe, observe your duty to Allah and give up what remaineth (due to you) from 'riba' if ye are (in truth) believers. And if ye do not, then be warned of war (against you) from Allah and His messenger. And if ye repent then ye have your principal. Wrong not and ye shall not be wronged".

The clear stipulation in this verse that from now on you can take back only your principal and the exclusion of anything over and above that principal leaves no doubt that simple as well as compound interest are prohibited in Islam. Similarly, there is unanimity among Islamic scholars that Islam prohibits interest on all types of loans, be they for consumption purposes or for productive investment and be they for short term or for medium term or long term.

A number of authentic sayings of the Holy Prophet (Peace be upon him) elaborate on the Quranic injunction prohibiting riba. These sayings also severely admonish those who dare to violate it as well as those who may be helpful in a riba transaction even as a scribe or witness. A lender is prohibited to accept from borrower any gift or even a small favour unless it was customary between the two of them to exchange gifts and other favours before the loan was granted.

Prohibition of riba in Islam necessitates that in countries desirous of promoting Islamic financial practices, banking should be organised on a basis other than interest. The present paper is concerned with the industrial financing techniques which can be employed by Islamic banks to promote industrial development of a country without infringing the teachings of Islam. The plan of the paper is as follows. The first section delineates the guidance that is available from the authentic works of the well known schools of Islamic jurisprudence for organising industrial financing activities of Islamic banks. The second section surveys the more recent literature which deals with the technicalities of designing actual operating procedures of industrial financing in the light of the guidance available in the juridical writings of fuqaha and the principles of Shariah in general. The third section examines the current practices of Islamic banks in regard to industrial financing. The fourth section contains certain concluding observations.

I

Though banks did not exist in the early Islamic period, the practice of financial resources of one party being used by another party in the conduct of business, trade or industry was fairly widespread. In the pre-Islamic period, all financial resources were mobilised on the basis of either interest or some sort of profit/loss sharing arrangements. Islam prohibited all dealings based on interest but allowed continuance of the system of profit/loss sharing. The two forms of profit/loss sharing which were predominantly in use in the pre-Islamic period are known as mudarabah and shirkah. The contribution of fuqaha lies in examining the features of mudarabah and shirkah as found in usage in the pre-Islamic period and building a corpus of juridical opinion in regard to the attributes that must be possessed by these two types of financial arrangements to make them fully compatible with the ethos of the value system of Islam. The wealth of fiqh literature on this subject is of invaluable help in organising the financing activities of banks on truly Islamic lines in the modern age. In addition to mudarabah and shirkah, the Fiqh literature on ijara, ijara wa iqtina, murabahah, bai muajjal and bai salam is also considered to be quite relevant in the context of modelling the operations of Islamic banks. However, while there is a general consensus about mudarabah and shirkah financing, there is a good deal of controversy as regards a widespread use of other forms in the conduct of Islamic banking.

This section of the paper is devoted to an enunciation of the main points found in fiqh literature relating to the above mentioned financial arrangements. The literature on the subject is so vast that a short paper like this cannot do justice to the enormous contribution made by fuqaha in this field. The treatment here does not aim at comprehensiveness; it merely tries to summarise the main ideas which, in the opinion of the author, are most relevant in the context of the actual conduct

of industrial financing activities by Islamic banks.[1]

(a) Mudarabah:

Mudarabah is a participative arrangement in which one party provides capital (termed as Rabbal Mal in fiqh literature) and the other (called Mudarib) utilises it for business purposes under an agreement that profit from the business will be shared according to a specified proportion but loss, if any, unless caused by negligence or violation of the terms of contract by the mudarib, will be borne by the rabbal mal. This type of contract is also known as qirad or muqaradah in fiqh literature.

The permissibility of the system of mudarabah in Islam, arises from the fact that while the practice of lending money on interest was prohibited explicitly by the Holy Qur'an, there is no specific reference to mudarabah in the Holy Book while the Prophet (Peace be upon him) allowed this system, which was already in practice, to continue.

It seems that Muslim jurists in early Islamic period were concerned with the fact that the system of mudarabah, though allowed in Islam, could possibly be used as an instrument of exploitation. They therefore set out certain limitations on the practice. At the same time, the genuine interests of the rabbal mal were also sought to be safeguarded. The salient features of a mudarabah contract as derived from fiqh literature may be set out as follows:

(i) The mudarabah capital should be in monetary form and not in the form of merchandise. However, according to some

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1. The bibliography at the end of this paper lists some of the well researched books and papers which have been of great help to the author in the writing of this section of the paper. Particular mention needs to be made of the entries at serial Nos. 4,7,8,10,14,17 and 21

fuqaha, merchandise could be acceptable as mudarabah capital if the mudarib is authorised to sell it at the outset and then use it as capital. Some fuqaha also approve of providing mudarabah capital in the form of tools and machinery.

(ii) The party that provides the mudarabah capital and the party that engages in business may each comprise many persons, i.e. the capital may be provided by several persons and the business may be carried out by several other persons. It is also permissible that capital may belong to one person and the party that utilises it in business may comprise of many persons. Another possible arrangement, whose legitimacy is also recognised, is that several persons may pool their capital while one person uses it for carrying on business.

(iii) Some fuqaha have limited the scope of mudarabah to mere commercial activities, viz., buying and selling. Others see no objection to scope of mudarabah being widened to include agriculture, industry and other economic activities.

(iv) Any partner can terminate the mudarabah agreement at any time. If there are more than two contracting parties, the contract can continue in favour of the remaining parties.

(v) The mudarabah agreement ends with the death of any one of the parties. Where there are more than two parties, the agreement may be continued by the remaining parties.

(vi) According to most fuqaha, stipulation of a time limit for a mudarabah agreement is lawful. According to some opinions, such stipulation is preferable. However, some fuqaha are against the stipulation of a time limit for a mudarabah agreement.

(vii) The mudarib can employ his own capital also in the mudarabah business but this requires general or specific permission of rabbal mal. With the same stipulation, the

mudarib can supply the mudarabah capital to another party under a mudarabah agreement or a shirkah agreement.

(viii) The mudarib is not allowed to lend to another party out of the funds collected under a mudarabah agreement without the express permission of the rabbul mal. Similar restriction applies to borrowing by mudarib from other persons for use in business.

(ix) The financial liability of the rabbal mal is limited to the amount provided by him except where he has increased his own liability by permitting the mudarib, on his behalf, to borrow or to make purchases on credit.

(x) Profit earned from mudarabah business will be distributed between rabbal mal and mudarib on the basis of proportions settled in advance. No fixed amount can be settled for any party.

(xi) In the event of a loss, except in case of loss having been caused by negligence of the mudarib or violation of the terms of the contract by the mudarib, the entire loss has to be borne by rabbal mal.

(xii) In a running business, losses will be made good by profit till the business comes to a close and accounts are settled finally.

(b) Shirkah

Shirkah means participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profit and loss in specified proportions. The salient features of a shirkah contract as derived from fiqh literature may be set down as follows:[2]

2. The fiqh literature contains discussion on several forms of Shirkah. However, the form of Shirkah most suited to serve as a basis for conduct of banking business is known as shirkat-inan and the discussion in this paper is related exclusively to this form of shirkah.

(i) There is no restriction on the number of persons entering into a shirkah agreement for the carrying out of any business permissible in Shariah.

(ii) It is not necessary for each partner to contribute evenly in the capital. Capital can be invested by partners in any agreed proportion.

(iii) It is not necessary that profits of shirkah business should be distributed among the partners in proportion to the capital contribution of each of the partners. However, the proportions in which profit will be distributed among various partners should be clearly specified in advance in the shirkah agreement.

(iv) Losses, if any, in shirkah business have to be borne strictly in proportion to the capital invested by each of the partners.

(v) No partner is responsible for the financial liability of other partners except in the case when such liabilities have been accepted by the joint business with the permission of all concerned parties.

(vi) In a running business, loss will be made good by profit till the business comes to a close and accounts are settled finally. At the time of the settlement of accounts, the original capital will first be set apart. Any amounts left after that will be deemed profit or in case of a shortage, loss.

(vii) Parties entitled to shares of the business profit may claim their share only when the suppliers of the originally invested capital have had their investments returned to them, either as actual possession of the capital or as a legal transfer in their favour.

(viii) Other conditions of shirkah business are more or less the same as mentioned in the context of mudarabah business.

(c) Ijara and Ijara wa iqtina

In the terminology of fiqh, ijara is a contract under which one party obtains the right to lawful usufruct from a certain lawful article hired from the owner of that article on a certain return. The permissibility of ijara in Islam arises from the fact that it was practised in the time of the Holy Prophet (Peace be upon him) and he did not disallow it.

The subject of ijara has been discussed quite extensively in fiqh literature. The following are some of the most important points emphasised by fuqaha in respect of this practice:

(i) The contract of ijara should clearly spell out the period of the usufruct and the return thereon to avoid any dispute between the parties concerned.

(ii) The contract of ijara can be rescinded if a defect is found which affects the usufruct of the article taken on ijara.

(iii) The contact of ijara stands dissolved in the event of the death of either of the contracting parties.

(iv) The contract of ijara can also be dissolved if it is demonstrated that the owner of the article given on ijara has a compelling need to sell that article.

A variant of ijara is ijara wa iqtina in which the owner of the article given on ijara agrees to the transfer of the ownership of the article to the person making use of it at the end of a specified period on having received all the payments due under the contract of ijara. This arrangement is also subject to the same conditions as stipulated by fuqaha in respect of simple ijara.

(d) Murabahah and Bai Muajjal

Murabahah is one of the various kinds of sale-purchase transactions discussed in fiqh literature. Three possibilities exist whenever a sale is made. Sale may be made at the cost price by the seller; this is the break-even point and is called tawliyah. Sale may be made at less than the cost price involving the seller in a loss; that is called wadi'ah. Supply of goods by the seller to the buyer at a specified profit margin mutually agreed between them is called murabahah. Terms of payment in a murabahah transaction could be either cash or deferred. All these three types of sale are permissible in Shariah.

Bai Muajjal is defined in fiqh literature as a sale against deferred payment, either in lump sum or in instalments. Unlike murabahah, the sale of the commodity under bai muajjal takes place without the seller declaring his profit margin. The essential element of bai muajjal which distinguishes it from a normal sale is the deferred payment. It should be noted that sale at a price higher than the cost price is not a necessary characteristic of bai-muajjal. Any sale which takes place on deferred payment basis, irrespective of whether the seller makes a profit, incurs a loss or breaks even, falls within the definition of bai muajjal. It is wrong, therefore, to translate bai-muajjal as "sale on mark up basis" though the two terms have begun to be used interchangeably in popular usage in certain circles.

Both murababah and bai muajjal are considered permissible in fiqh literature. A good deal of controversy, however, exists on the point whether the price charged under bai muajjal can be higher than the prevailing market price of the goods sold. Islamic scholars do not equate charging of a higher than the market price in bai muajjil transactions as equivalent to riba but disfavour its widespread use as it is indicative of an usurious mentality.

The fuqaha have emphasised that in all sale transactions all risks attendant on such sale should be borne by the seller until the possessior of the goods sold has been passed on to the buyer. Some writers insist that the buyer should enjoy the option of refusing to take the delivery of goods he had asked the seller to supply; this is technically known as khiyar in fiqh literature.

(e) Bai Salam:

Bai salam is the opposite of bai muajjal and signifies sale/purchase deal in which buyer pays the agreed price of a commodity in advance and the commodity is to be delivered to the buyer on a specified future date. Like many other modes of sale, this mode was also prevalent in the time of the Holy Prophet (Peace be upon him). In general, the Holy Prophet (Peace be upon him) laid down the principle that the sale of a commodity which is not in the possession of the seller is unlawful. However, keeping in view the problems faced by the farmers and traders, the Holy Prophet (Peace be upon him) permitted advance sale with certain conditions. A good deal of fiqh literature is available on this subject. The following points have been specially emphasised by fuqaha in respect of bai salam:

(i) It is permissible only in the case of commodities whose quality and quantity contracted for sale can be precisely determined in advance.

(ii) The period for the delivery of goods has to be precisely fixed.

(iii) Both parties have the right to rescind the contract in full or in part.

(iv) In the event of the death of the seller, the contract will be deemed to have been rescinded and the buyer can claim the return of his money from the heirs. In the event of the

death of the buyer, however, the contract will remain operative.

II

Banks in most countries are an important source of industrial finance. Manufacturing concerns require both short term and long term finance. Short term finance is needed for meeting working capital requirements. Medium and long term finance is needed for purchase of plant, machinery and other fixed assets at the time of the initial establishment of an industry and later for balancing, modernisation and expansion. In traditional, or western-type financial systems, banks provide finance for fixed investment by way of term loans or purchase of debentures or participation in underwriting arrangements. Working capital requirements are financed through grant of demand loans, cash credit, overdraft, opening of import letters of credit and bill discounting. Usually for the opening of letters of credit, only commission is charged while in all other cases finance is provided at fixed interest rates.

Considerable thought has been given in recent years to finding alternative ways of meeting the various financing requirements in an interest free context. Intensive work has been done in this field in Pakistan and Iran, the two countries which have made considerable headway in abolishing the interest-based system on an economy-wide basis. Studies have been conducted in other countries also to replace interest-based instruments of finance by alternative financial devices. Guidance for devising alternative mechanisms of financing so as to get rid of interest has generally been sought from the fiqh literature on Muamlat-ul-Malia.

In designing operating procedures of interest free banking modern scholars have tried to follow as closely as possible the precepts of the highly respected fuqaha of the second and

third Islamic centuries. However, in matters on which the Qur'an and Sunnah provide no specific injunction, they have, where necessary departed from some of the opinions of the fuqaha of the early Islamic age in order to find practical solutions to modern day problems. This is considered perfectly legitimate activity in consonance with the objectives of Shariah and aids the growth of Islamic jurisprudence to meet the challenges of the modern age.

The earliest contributions to the modern literature on the conduct of banking without interest are found in the works of certain authors in the late forties followed by more elaborate exposition in later years.[3] Among the latest contributions to the subject is the Report of the Council of Islamic Ideology on the Elimination of Interest submitted to the Government of Pakistan in 1980 (later referred to as CII Report) which has been widely acclaimed as a detailed blue-print for reorganisation of banking practices and procedures on the basis of the well known legal concepts of mudarabah and shirkah.

The models of interest free banking presented in almost all these contributions have certain common features. The hard core of all these models is a two-tier mudarabah contract, the first among the depositors and the bank, and the second between the bank and the parties to whom finance is provided. There are some differences, however, in regard to the suggested details of certain aspects of the working of these banks.

It is important to note that while outlining the mode of operations of interest free banks, the exponents of Islamic banking have not suggested any change in the basic institutional structure of the modern day banking system. They are of the

3. For details, see "Muslim Economic Thinking: A Survey of Contemporary Literature" by Muhammad Nejatullah Siddiqi in Khurshid Ahmad (ed) Studies in Islamic Economics (The Islamic Foundation, United Kingdon, 1980).

view that banks can continue to perform the same functions as in the Western financial system but their operating procedures would be modified to replace interest based transactions by modes of finance which are permitted by *Shariah*.

It is generally recognised that in the practice of Islamic banking maximum possible use should be made of the techniques of *mudarabah*and *shirkah*. In the case of *mudarabah*, the bank would not participate in the management of the business financed. It could, however, exercise adequate supervision to ensure that the funds were being used in accordance with the *mudarabah* agreement. This would make the banks *mudaribs* with respect to their depositers and *rabb ul mal* with respect to the clients to whom they provide finance. This is what has come to be known as a two-tier *mudarabah* in the current literature on Islamic banking.

In the case of *shirkah*, the bank could also participate in the management of the business. However, in view of the complex nature of modern business organisations and in the interests of minimising the administrative costs, *shirkah* mode of financing is not likely to be used as extensively as *mudarabah* in the actual practice of Islamic banking.

While *mudarabah* and *shirkah* are regarded as ideal substitutes to interest in Islamic banking, the Islamic banks can make use of certain other devices like *ijara*, *ijara wa iqtina*, *murabahah*, *bai muajjal* and *bai salam* in their operations. The *fiqh* literature provides guidelines in respect of these devices also. Recent literature on Islamic banking has shown how these concepts can be translated into actual operating procedures in the conduct of interest free banking.

The concepts of *ijara* and *ijara wa iqtina* have their counterpart in the Western financial system also in the form of leasing and hire-purchase respectively. Leasing as a technique of industrial financing is progressively gaining ground in a

number of countries which have interest-based banking systems. Broadly speaking, there are two main types of leasing arrangements: financial leases and operating leases. Islamic scholars have studied the Western practices of leasing and have come to the conclusion that there seems to be nothing objectionable from Shariah point of view in as far as operating leases are concerned. However, some scholars have raised doubts about the permissibility of financial leases as, unlike the case of operating leases, these are non-cancellable and the risk of damage to the equipment, not related to its use, and its obsolescence is borne by the lessee which puts him in an unduly disadvantageous position.

The hire-purchase system can also be used by Islamic banks in the conduct of their operations. A suitable operating procedure for this system has been suggested in the CII Report to which a reference has already been made. The Report states: "A variant of the hire-purchase system may be used in financing purchase of machinery and equipment as well as purchase of consumer durables in economically justifiable circumstances. Under this system, banks may finance the purchase of these items under a joint-ownership arrangement subject to provision of security or surety. They would receive, in addition to repayment of the principal, a share in the net rental value (after allowing for depreciation) of these items in proportion to their outstanding share in total investment. The items may also be insured and the cost of insurance may be shared between the bank and the other party proportionately on the basis of their outstanding investment. However, unforeseen repairs may be entirely the responsibility of the user of the equipment."

The CII Report has also outlined the operating procedure of bai muajjâl, which is defined as a sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments. The mechanism of this system is set out in the aforesaid Report as follows: A business firm

needs finance from a bank to purchase/import an item from a domestic seller/manufacturer or foreign exporter. Instead of discounting a bill or making an advance, the bank under an agreement with the firm concerned may purchase/import the commodity on its own account and sell it to the firm at a price, to be settled in advance, which includes a mark-up over the cost price for a reasonable profit margin for the bank. Payment from the firm would be receivable by the bank after the agreed period." The Report further points out that "Although to be in conformity with the Shariah, it is necessary that the sale item should come in the possession of the bank before being handed over to the other party, however, that would be sufficient for this purpose if the supplier from whom the bank has purchased the item sets it aside for the bank and hands it over to any person authorised by the bank in this behalf, including the person who has purchased the item in question."

It has already been mentioned that Islamic scholars do not equate charging of a higher than the market price in bai muajjal transactions as equivalent to riba but disfavour its widespread use as it is indicative of an usurious mentality. The CII Report therefore gave only qualified approval to the use of bai muajjal as a financing device and cautioned against its indiscriminate use in the following words: "However, although this mode of financing is understood to be permissible under the Shariah, it would not be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back-door for dealing on the basis of interest. Safeguards would, therefore, need to be devised so as to restrict its use only to inescapable cases".

The CII Report does not discuss murabahah explicitly but it is obvious that in terms of its acceptability and desirability as a financing device it falls in the same category as bai-muajjal if the sale price of the commodity is fixed higher than the market price on account of payment being made at a future date either in lump sum or in instalments.

The operating procedure of <u>bai salam</u> is quite simple. The bank enters into an agreement with a client for advance purchase of certain goods of stated specification and makes the payment of the agreed amount at the time of entering into the agreement. Like <u>murababah</u> and <u>bai muajjal</u> this device could also be used by Islamic banks but for similar reasons its widespread use cannot also be commended.

So far the discussion in this section of the paper has dealt with financial devices whose operating procedures are directly deducible from the material available in <u>fiqh</u> literature. Apart from these, a number of other devices have been suggested which could possibly be used by Islamic banks as they do not involve the giving and taking of interest. Some of these are briefly set out below:

(a) <u>Special Loans Facility:</u> Islamic banks cannot charge any interest on loans. However, temporary financial accommodation can be granted by them in the form of loans, as a special facility, against a service charge or without even a service charge. Such a facility could be extended to small business and cottage industries to serve a social purpose. It should be noted that, in order to conform to <u>Shariah</u>, the service charge will have to be no more than the actual cost incurred in the administration of such loans.

(b) <u>Time multiple counter loans:</u> Under this method a bank may give by way of interest free loan a multiple of interest free deposit by a client in such a manner that the product of money and time for which money is given is the same in both cases. The CII Report mentions this possibility but cautions that it would not be correct to use this method by way of a permanent alternative to interest-based system.

(c) <u>Financing on the basis of normal rate of return</u>. Under this method, a specialised public agency may determine the normal rate of return in each industry, business etc. and the

banks may provide funds to the entrepreneurs with the assurance that the ascertained minimum rate of profit would be payable to the bank on the amount provided by it. The agreement should also provide that if the actual rate of profit exceeds the designated normal rate of return, the difference would be voluntarily paid by the entrepreneurs to the financing institution. In case, however, the rate of profit turns out to be lower, or if there is a loss, the entrepreneur concerned would have to prove the same to the satisfaction of the specialised public agency in which event the bank will accept the lower rate of profit or share in the loss.

While discussing this method of financing, CII Report states that although it does not violate the principles of Shariah because the basis of transactions is sought to be the actual operational results while the normal rate of return has largely an indicative value, there is a strong possibility that its widespread use may in practice degenerate into pure interest with the passage of time. The Report, therefore, emphasises that if need arises to use this method, it should be used on a very limited scale and sparingly.

(d) Investment Auctioning: This method also has been discussed in CII Report to replace interest in the case of long and medium term financing in the industrial sector. Under this method, the financing agency may itself formulate an industrial project with complete details. The financing agency may then announce the project with the assurance to make available the needed plant and machinery of specific description and call for bids from prospective investors for the purchase of the machinery. The project may be awarded to the highest bidder if the party is considered to be a sound one. Otherwise, the project may be awarded to the next highest bidder considered capable of efficient management of the project. The successful bidder would not be asked to pay the price of the plant and machinery straight away but would be afforded the facility of

of paying the amount in instalments over an agreed period.

(e) Underwriting of shares and purchase of equity at a negotiated price.

Provision of funds through underwriting of shares is regarded as a legitimate activity of an Islamic bank provided it is not tied up with arrangements like "bridge financing" involving fixed rate of interest. Islamic banks can provide the financial requirements of an industry in its gestation period by taking up a part of the equity at the very inception of the project at a negotiated price which can be below the face value of the shares. Since the future value as well as the yield from the shares so acquired by a bank cannot be predicted in advance the operation entails a certain amount of risk and is compatible with Shariah.

(f) Issuance of Mudarabah Certificates : Issuance of Mudarabah Certificates can enable a financial institution to mobilise funds on mudarabah principles. Mudarabah Certificates can be Specific Purpose Mudarabah Certificate or General Purpose Mudarabah Certificates. Specific Purpose Mudarabah Certificates can be designed to finance specific projects with a well defined maturity period while proceeds of General Purpose Mudarabah Certificate can be invested in all Islamically permitted avenues of investment. Both types of certificate can be issued in negotiable form, either registered or bearer. Mudarabah Certificates can be distributed in an underwriting or sales effort of a fixed term or be continuouly available or be available on a periodic basis.

(g) Issuance of Participation Term Certificates: Debenture financing, which is a very common method of financing fixed investment in industry in the interest based system, can be replaced by the issuance of a new corporate security which may entitle its holders to share in the profits of the concern issuing it instead of receiving a fixed interest. The CII Report suggests that the new corporate security be called Participation

Term Certificate.

(h) An alternative to bill discounting: Bill discounting is a very common method of providing short term finance to business and industry in the interest based system. Islamic banks cannot engage in this practice on account of the prohibition of interest. The CII Report has suggested an alternative to bill discounting which is compatible with Shariah. The suggested procedure is as follows. Since the bank accepts the responsibility of realising the amount due to the drawer from the drawee, it is permissible under the Shariah that the bank may realise a commission for rendering this service. This commission will be variable according to the amount of the bill, but not according to the period of payment. The drawer will have to enter into two separate agreements with the banks, one pertaining to the appointment of the bank as his agent for the collection of the amount from the drawee on the due date and other for receiving a loan in the amount equal to the value of bill. The bank's commission will be payable in advance and the loan will be free of interest. On collection of the bill, the bank will adjust the loan account of the drawer. In case the bill is dishonoured, the drawer will be liable for payment of the loan amount to the bank.

With such a wide array of financing mechanisms available, Islamic banks should be able to meet all types of industrial financing requirements without infringing the principles of Shariah.

III

Islamic Banking is no longer confined only to the realm of ideas. It has passed the stage of model building. It has been given a practical shape in a number of countries and has made a place for itself in the world of finance.

Leaving apart Pakistan and Iran which have made considerable headway in establishing a completely interest free banking system on an economy wide basis, there are now 57 Islamic banking and financial institutions in the rest of the world, out of which 8 institutions are operating at an international level.[4] The Islamic financial institutions currently operating in various countries include Islamic banks, Islamic investment companies, Islamic national and international holding companies and Islamic development finance institutions.

Islamic banks are performing all general banking services without involving interest. They handle current accounts, saving accounts and investment accounts. Financing is done in a variety of ways to cater to the needs of trade, industry, agriculture and services. Murabahah and Bai Muajjal are the most widely practised techniques at present for meeting short term financing requirements of trade, industry and agriculture. Medium term and long term financial requirements are met by using the techniques of Mudarabah, Shirkah, Ijara and Ijara wa Iqtina. The Islamic commercial banks also perform international banking services for foreign exchange transactions, purchase and sale of currencies, purchase and sale of internationally traded commodities, transfer of funds, export financing, letters of credit and letters of guarantee. They also undertake miscellaneous services which include safe deposit facilities, management of private investment portfolios and trustee functions.

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4. For details see "The Present State of Islamic Finance Movement", a paper presented by the author at the Conference on the Impact and Role of Islamic Banking in International Finance: Issues and Prospects held under the auspices of Arab-US Chamber of Commerce in New York in June, 1985.

The Islamic investment holding companies have either a national or an international mandate and have been fairly active in promoting the growth of various types of Islamic financing institutions. The Daral Maal Al-Islami deserves special mention in this connection. It is an international holding company and has played a dynamic role in promoting Islamic financial institutions in various parts of the Muslim world.

The Islamic investment companies and Islamic development finance institutions have assisted the process of economic development in Muslim countries by providing medium and long term finance for the development of industry, agriculture and other sectors. Compared to Islamic commercial banks, the Islamic investment companies are easier to set up because they do not require large office facilities nor do they require large share capital. Yet their role in assisting the development of the productive potential of the Muslim world is very crucial. Among the Islamic development finance institutions, the pride of place belongs to the Islamic Development Bank. It is playing an important role in assisting the development of infra-structural facilities in the Muslim countries and has also helped in the promotion of directly productive activities in various sectors of the economies of these countries.

Working results of individual Islamic financial institutions show that the resources mobilised by them have grown steadily over the years. This indicates the confidence of the general public in their soundness and viability. They have also generally maintained a good record of profitability and the return paid by them to their investment account holders and share-holders compares well with those of traditional banks working in the same geographic locations.

In Pakistan and Iran, the transformation from traditional banking to Islamic banking on an economy-wide scale has been accomplished without any major problems. The range of banking

services offered by the commercial banks has not been adversely affected. New ways of providing medium and long term finance through new financial instruments like Participation Term Certificates have taken firm root in Pakistan. The central banks of both Pakistan and Iran have maintained their effectiveness in supervising and regulating the actions of the commercial banks in the new milieu characterised by the adoption of Islamic financing practices. Leaving apart the Bank Rate, most of the traditional instruments of central banking control like cash reserve requirements, liquidity requirements and selective credit controls can continue to be used by the central banks of the Islamic financial system. Besides, to replace the Bank Rate mechanism, central banks in both Pakistan and Iran have been empowered to regulate the profit sharing ratios to influence the overall aggregate demand in the economy as well as sectoral financial flows to achieve the desired monetary policy objectives.

There is growing literature now on the operational details of the working of individual Islamic financial institutions. This shows that though all Islamic banks and other financial institutions mobilise investment resources on the principle of profit/loss sharing, practice in respect of development of these resources differs a great deal. It is not possible within the short span of this paper to go into the details of these variations. However, some observations will be made on the actual operating procedures being employed by Massraf Faysal Al-Islami (MFI), the name given to a series of Islamic banks controlled by Daral Maal Al-Islami, and those being employed by commercial banks in Pakistan to illustrate the nature of these variations, particularly in respect of their industrial financing activities.

The Daral Maal Al-Islami is very particular in ensuring that all the financing techniques employed by MFI are in conformity with Shariah. To achieve this purpose every bank controlled by DMI has a Religious Supervisory Board which keeps a watch on its dealings. The procedure for the constitution of the Religious Supervisory Board is more or less similar to those

for appointment of External Auditors and is intended to guard their independence. Through the institutional mechanism of the Religious Supervisory Board, managements of banks have easy and continuous access to religious scholars reputed for their piety and knowledge of Islam for consultations in evolving the operating procedures of the banks, and the scholars in turn have full opportunity of scrutinising their actual operating procedures.

A survey[5] of the operating procedures of MFI shows that the main techniques of industrial financing employed by them consist of mudarabah, shirkah, qard hassana, murabahah, ijara and ijara wa iqtina. Finance under the mudarabah system is provided on the basis of MFI's Standard Mudarabah Contract whose main features are as follows: (a) Mudarabah financing is given on the basis of detailed cash flow and Distributable Revenue (as defined) projections prepared by the client, the substantial correctness of which is warranted by the client. (b) Project expenses and project income are monitored through a controlled account at MFI. (c) Except as noted in (d) below, the client provides management services without charge in consideration of the client's participation in profits, if any. (d) The client supplies ancillary support or overhead services, either at his own expense or for a fixed payment, thereby reducing accounting problems in determining the Distributable Revenue (in which MFI shares) and increasing the predictability of such Distributable Revenue. (e) Quarterly reporting of variation from cash-flow and Distributable Revenue projections are required. (f) The definition of Distributable Revenue (to which MFI looks for reimbursement of principal and profit) varies with the project to fit the accounting sophistication of the client and afford a high degree of predictability. (g) MFI's continued participation in the Distributable Revenue of the project is normally limited to the return of investment plus a described internal rate of return on MFI's outstanding investment, thus liquidating MFI's equity investment. (h) Stringent liabilities are imposed in the event of the breach of any contractual obligation to manage the

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5. The account of the operating procedures of MFI in this paper draws heavily on the material contained in a document of Dar Al-Maal Al-Islami entitled "Principles of Islamic Banking: Massraf Faysal Al-Islami (MFI) published in Journal of Islamic Banking and Finance, quarterly publication of the International Association of Islamic Banks, Karachi Vol.3, No.1.

project for MFI's benefit. (i) MFI may itself assume project management in the event of breach or failure of operating results to achieve projected cash-flow or Distributable Revenue.

MFI make financing available under the Shirkah system also on the basis of a standard contract. As a juridical form, shirkah is identical to mudarabah except that in addition to supplying management and other services, the MFI client shares with MFI in providing a part of the equity also. The client therefore receives for such equity a defined percentage participation in the same Distributable Revenue to which MFI looks for the recovery of its investment plus profit. Except for the changes in the MFI basic form of Mudarabah contract required to reflect the client's investment on terms pari passu with MFI, MFI's standard Shirkah Contract is identical with the standard Mudarabah contract.

It is interesting to observe that in addition to mudarabah and shirkah, MFI make use of qard hassana (interest free loan) also in financing industrial activities. Such interest free loans are normally extended to clients to whom MFI is providing finance in other forms, particularly mudarabah and shirkah. Combining a loan with participation forms of financing has the effect of limiting MFI's risk with respect to the total investment as, according to principles of Shariah, it is the moral as well as the legal obligation of the recipient of a loan to repay it in full in accordance with the terms of the loan agreement. Loans are made by MFI under a standard form of Loan Agreement and the indebtedness is evidenced by negotiable promissory notes. The Loan Agreement contains relatively standard balance sheet warranties in addition to quarterly reporting requirements for monitoring actual cash flow in relation to cash flow projections.

The murabahah form of contract is used by MFI to finance the acquisition of capital goods or raw materials or other merchandise by MFI's clients. The goods are purchased by MFI

from a third party at the request of its client and are then resold to the client at cost plus a reasonable profit. The amount receivable by MFI can be paid by the client either in lump sum or in instalments as agreed between the two parties. Keeping in view the Shariah requirements, murabahah form of financing is utilised only if (a) the goods are truly purchased by MFI from a third party, the equivalent of a sale and lease back in murabahah form being expressly forbidden (b) MFI truly takes title to the goods and (c) MFI bears the risk that the client may not observe his obligation to buy the goods purchased under his instructions. Under MFI's standard form of contract, MFI's clients look only to the original supplier with respect to the warranty of the quality of the goods. MFI may require the client to sign non-interest bearing promissory notes evidencing his obligation to make payments of amounts due on specified future dates. The contract provides that in case of necessity, MFI may sell or dispose of its claim against its client to third parties at a negotiated price which can be less than the face value of such claim. The following observation in the document of Daral Maal Al-Islami is pertinent in respect of the legitimacy of this type of transaction under Shariah:"Islamic law prohibits the purchase of fixed obligations at a discount from the issuer. However, fixed obligations acquired from the issuer in an Islamically proper transaction at par can be subsequently transferred by the recipient at less than par. Islamic principles would not permit 'discounting' of such fixed obligations by MFI to third parties as a standard business practice."

MFI help the process of industrial development by making industrial equipment available to the clients on the basis of ijara. Under the MFI's Standard Ijara Contract, the client accepts the responsibility to make the agreed periodic rent payments irrespective of the state of his business. The contract grants the client an option to purchase the equipment throughout the term of the agreement. The optional purchase price declines

over the term of the agreement and is computed to give MFI a slightly increased margin of profit if exercised. MFI regard an Ijara Contract a preferable mode of financing compared to murabahah in cases where they do not have full trust in the credentials of the client.

MFI's standard Ijara wa Iqtina Contract is almost identical to the Ijara Contract with the main difference that the optional purchase price is replaced by a mandatory purchase price. The client is required to make prescribed periodic principal payments into a blocked Investment Account to secure his obligation to purchase the goods with the profit or loss of such account accruing to the client.

Pakistan and Iran are two countries where interest has been sought to be abolished on an economy wide basis. The process of the Islamisation of the banking system in Pakistan commenced on January 1, 1981 when all the seven thousand branches of Pakistani commercial banks started accepting deposits on profit/loss sharing basis while interest bearing deposits also continued in the system. The parallel system was, however, ended during the course of 1984-85, and as from July 1, 1985 no banking company accepts fresh interest bearing deposits, except foreign currency deposits which are outside the new system. As for the deployment of interest-free deposits, the State Bank of Pakistan, which is the central bank of the country, has laid down the following twelve modes of financing:

A. Loan Financing by Lending:

(i) Interest-free Loans with service charge, on which the banks may recover a service charge not exceeding the proportionate cost of operations, excluding the cost of funds and provision for bad and doubtful debts. The maximum service charge permissible to each bank will be determined by the State Bank from time to time.

(ii) Qard-e-Hasanah loans given on compassionate ground free of any interest or service charge and repayable if and when the borrower is able to repay.

B. Trade-Related Modes of Financing:

(iii) Mark-up: Purchase of goods by banks and their sale to clients at appropriate mark-up in price on deferred payment basis. In case of default, there should be no mark-up on mark-up.

(iv) Mark-down: Purchase of Trade Bills and notes of credit on the basis of mark-down in price.

(v) Buy-back: Purchase of movable or immovable property by the banks from their clients with Buy-back agreement or otherwise.

(vi) Leasing: Rental of equipment for a fixed amount over a pre-determined period to project sponsors by the banks.

(vii) Hire-Purchase of an article on payment of rental and price instalments, over an agreed period, whereafter the ownership of the article is transferred to the lessee.

(viii) Financing for development of property by the banks on the basis of development charge.

C. Investment Modes of Financing:

(ix) Musharaka: Bank financing for investment on the basis of sharing in the profit and loss of the enterprise.

(x) Equity Participation will allow banks to purchase shares of the listed corporations.

(xi) Participation Term Certificates (PTCs) and Mudarabah Certificates can be issued by companies, within broad guideline provided by the government, on terms governing maturity, profit and loss sharing, and repayment as agreed between the company and the purchaser.

(xii) Rent Sharing will allow Banks to form partnerships with their clients in the purchase of property on the basis of sharing in the rental or any other income from the property.

In the field of corporate finance, debentures have been replaced by a new financial instrument known as Participation Term Certificate (PTC). Instead of receiving interest, as in the case of debentures, the holders of PTCs share in the profit and loss of companies raising finance through this device. The PTCs have the following features:[6]

(a) The certificates are issued for a specified period not exeeding ten years, excluding the grace period.

(b) The broad principles governing the legal aspects of Participation Term Certificates are prescribed by the government by making suitable amendments in the statutes governing the operations of corporate entities.

(c) As PTC finance is provided for a specific period, it is secured by a legal mortgage on the fixed assets of the company. It also enjoys a floating charge on the current assets.

(d) For the purpose of allocation of profit to PTC holders, the investment ranks pari passu with equity and share in profit on a basis to be determined by mutual agreement.

(e) Profits for the purpose of determining return to the PTC holders are taken to be pre-tax profit before appropriations.

(f) Profit payable to PTC is treated as deductible expense for income tax purppose.

(g) The share of PTC holders in the profit is deducted prior to the claim of share-holders in the profits of the company in any given year.

(h) In case of loss, the first recourse is made to the free reserves including the credit balance in the profit and loss accounts of the issuer and the balance of the loss is shared between the PTC holders and other providers of funds in proportion to their funds.

(i) The proceeds of PTCs are used exlusively for the project or the business concerned. The sponsors are

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6. This description of the features of PTCs is based on the system as in vogue in Bankers Equity Limited, an institution whose main field of operations is equity financing. The description is based on an article by the Managing Director of the institution which appeared in Journal of Islamic Banking and Finance, Vol.1 No.2, a publication of International Association of Islamic Banks, Asian Region, Karachi.

required to give an undertaking to conduct the business with diligence and efficiency in accordance with sound engineering, financial and business practices and such other terms as may be agreed between the parties.

(j) In order to provide protection to the purchasers of PTCs, a trustee is appointed who is responsible, among other things, for the appraisal of the business or the project. The trustee has the right to call for any information from the company, visit premises where the business or the plant and machinery of companies are located and have access to their records.

(k) An option is also given to the PTC holders to convert a certain portion of outstanding Participation Term Certificates into ordinary shares.

(l) A right option is also given to the existing ordinary stock-holder to subscribe to the fress issues of PTC.

To regulate financing on the basis of mudarabah, a comprehensive Mudaraba Companies Ordinance was promulgated in June 1980. The main features of this law are as follows:

The Mudarabah companies and Mudarabah (Floatation and Control)Ordinance, 1980 provides that any company registered under the Companies Act or a body corporate formed under any law in force, owned or controlled, whether directly or through another company or corporation by the Federal Government or Provincial Government can undertake Mudarabah business. However, there are certain pre-requisites which must be fulfilled before any company undertakes the business of management of Mudarabah. Chief among these are:

(i) If a company is formed solely for the purpose of floating and managing a Mudarabah, it must have a paid up capital of not less than rupees five million.[7] In the case of

7. In the Bill recently passed by the National Assembly of Pakistan this limit has been reduced to Rs.2.5 million. Companies which may float Mudarabah in addition to their other business activities are required to have a minimum paid up capital of Rs.7.5 million.

existing companies which are engaged in other business and want to float a Mudarabah, the minimum amount of paid up capital exclusively set aside for management of mudarabas will have to be presented separately;

(ii) No director, officer or employee of the company has been convicted of fraud, breach of trust or an offence involving moral turpitude;

(iii) No director, officer or employee of such a company has been adjudged an insolvent or has suspended payment or compounded with his creditors;

(iv) The promoters are persons of means and integrity and have knowledge of matters with which the Mudarabah company will deal:

(v) The company is registered with the Registrar as Mudarabah company and has obtained permission of the Controller of Capital Issues and Registrar for floatation of Mudarabah; and

(vi) A clearance is obtained from the Religious Board to the effect that the business proposed to be carried on by the Mudarabah is not opposed to the injunctions of Islam.

Following conditions are applicable to Mudarabah, viz., (i) The Mudarabah will be a legal person, which can sue and be sued in its own name. (ii) The assets and liabilities of each Mudarabah will be separate and distinct from each other as well as from those of the Mudarabah company. (iii) For each Mudarabah, separate bank accounts, funds, assets and liabilities will be maintained. (iv) Mudarabah Certificates shall be issued within thirty days of allotment. (v) No Mudarabah shall be liable for the liabilities of or be entitled to benefit from the assets of any other Mudarabah or of the Mudarabah Company.

In order to ensure that the interests of the investors are protected, a number of safeguards have been provided in the law. These include (i) A business repugnant to Islam is prohibited. (ii) The Mudarabah Company must subscribe at least 10% of the total amount of Mudarabah Certificates offered for subscription in each Mudarabah. Thus the Mudarabah company is also financially involved in a Mudarabah which makes the Mudarabah bilateral in

character. (iii) The Certificate holders will get, within six months of the close of the accounting year: (a) The annual balance sheet and profit and loss account; (b) report of the Auditor; and (c) report of the Mudarabah Company on the state of affairs, activities and business prospects of the Mudarabah.

To safeguard the banks against undue delays and defaults in repayment by parties obtaining finance from them, a new law, called the Banking Tribunals Ordinance, 1984, was promulgated. Under this law, the Federal Government shall appoint banking tribunals with specific territorial jurisdictions, each headed by a high-ranking Judge. The tribunals are required to dispose of all cases within 90 days of the filing of the complaint. Appeals against the verdicts of tribunals can be filed in the High Courts within 30 days but the decretal amount has to be deposited with the High Court of appeal. In cases where the decree remains unsatisfied beyond a period of 30 days, the tribunals can also impose fines.

It will be seen from the above description of the steps taken that an elaborate framework has been laid down for the conduct of Islamic banking in Pakistan. However, unlike the case of MFI, many of the interest free modes of financing being employed by banks and other financial institutions in Pakistan have not yet been standardised. In fact, mudarabah is the only form of financing whose dimensions have been clearly spelt out through specific legislation on the subject. No specific law has so far been enacted to govern and regulate the financing through shirkah or musharika arrangements. The banks as well as the client companies have been allowed the option either to enter into musharika arrangements or deal on the basis of some other permissible modes of financing. In case of musharika, the parties have been allowed the flexibility of negotiating the terms of the arrangements though the range of profits to be earned by banks in such arrangements has been laid down by the State Bank of Pakistan. In the case of Participation Term Certificates (PTCs) also, there was no standardisation and it

was only after the promulgation of the new Companies Ordinance, 1984 that regulations governing the issue of PTCs were laid down.

Some uniformity in the procedures governing various modes of financing could have emerged, even in the absence of legal standardisation of these modes of financing, had the operations of banks been made subject to surveillance by a Religious Supervisory Board as in the case of MFI. Since this was not done, the operating procedures remained disparate and banks and other financial institutions adopted certain practices which were clearly not in conformity with Shariah. Thus, for quite some time after the introduction of interest free banking, recourse was taken to "mark up over mark up" in the event of non-payment of amount due from the client on the date stipulated in the agreement ostensibly based on the concept of bai-muajjal. This drew strong criticism from religious circles and,following continuous protests on this issue, the practice of "mark up over mark up" was abandoned as from July 1, 1984.

Some of the musharika agreements entered into between banks and their clients also departed in certain respects from the requirements of Shariah. They contained a provision for greater weightage being assigned to the amount invested by the bank in the sharing of profit compared to the equity of the business enterprise. This ran counter to the concept of equitable sharing of profit under musharika because if at all any weightage appears desirable it is in respect of the business concern's own investment because besides capital, it is contributing business management and expertise. A number of musharika agreements also contained a provision that the legal relationship between the parties to the contract, that is, the bank and the business entity would be that of debtor and creditor. This has also drawn strong criticism from Islamic scholars.

The Participation Term Certificates were introduced to replace interest bearing debentures by a financial instrument

based on profit/loss sharing in consonance with Islamic ideals of equity and justice. However, PTCs as originally issued had a provision for payment of a pre-production discount rate during the gestation period of the project. This and some other features of PTCs have drawn criticism from interested observers.[8]

The inclusion of devices like "Buy-back" and "mark down" in the "permissible" modes of financing notified by the central bank of the country has also been criticised in circles well versed in Shariah matters. The Economic Survey published by the Economic Adviser's wing of the Ministry of Finance of the Government of Pakistan in June 1985 acknowledged that "According to the Ulema (religious scholars) the form in which PTCs have so far been issued, Buy-back arrangements and Mark-down do not conform to the Shariah ... Influenced by the position of the Ulema, a number of doubts remain in the minds of the common public about the Islamic modes of saving and financing".[9]

Notwithstanding the controversy surrounding some of the practices currently in vogue in the name of Islamic banking, there is no doubt that Pakistan has made an irrevocable commitment to bring all its banking practices in conformity with the requirements of Shariah. Government have been receptive to the criticism voiced by religious sholars in regard to certain aspects of the Islamisation process and taken corrective steps as evidenced in the decree to abandon the practice of "mark up over mark up". Experts are keeping a vigilant eye on the working of the new system and it is hoped that Shariah aspects will be fully kept in view in the growth and development of Islamic banking system in the country.

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8. See, for example, Waqar Masood Khan, Towards an Interest Free Islamic Economic System (Islamic Foundation, U.K., 1985) pp. 96-99.

9. Pakistan Economic Survey (1984-85), (Government of Pakistan, Economic Adviser's Wing, Finance Division, Islamabad). pp.10--11.

IV

Islamisation of the banking system is a delicate and challenging task. The concept of Islamic banking represents a radical departure from the banking practices developed in the West. The Western banking system has evolved on secular basis and is not conditioned in its operations by any religious commandments. Islamic banking, on the other hand, has to derive its inspiration from the religious edicts of Islam. The philosophical foundation of Islamic banking is derived from a verse of the Holy Qur'an which says that God has permitted bai (trading) and has forbidden riba (interest). Essential element of "trading" is that the return on capital employed depends upon the actual operating results of the business undertaken. To apply this principle to modern modes of business finance it is necessary to replace interest by a system of shared risk financing. This of course is a revolutionary concept because Western banking theory and practice emphasise the minimisation of risk.

It should, however, be noted that risk sharing is not entirely unknown to the Western system of banking. For instance, the history of the development of banking in Germany shows substantial equity financing on the part of major banks in that country. In France, the banques d'affaires, which represent an important part of the banking system, undertake investment financing on participation basis. In Japan before the second world war, commercial banks activity participated in underwriting of shares and in the post-war period also the underwriting business continues to be strongly influenced by them.

The significant fact is that the character of banks and their operating procedures and practices are largely determined by the national priorities and the particular situation obtaining in the country in which they operate. For instance, in spite of the long enduring political association as well as ethnic and racial links between the United States and Britain, the

development of banking in the United States proceeded on a radically different pattern, reflecting deep imprints of the local conditions and the social attitudes and behaviour. With the changing requirements of the time even the British banks have departed from the traditional practice of confining themselves to short term lending and have increasingly engaged in medium term financing after the second world war. A large number of industrially advanced countries are presently concerned about the surfeit of loan capital and shortage of risk capital and are thinking of ways of overcoming this problem. The rapid growth of venture capital institutions in U.K., U.S.A. and other countries has provided a partial answer to this problem. In general, banking industry in the West is witnessing notable growth in non-conventional methods of financing.[10]

Considering the variety of the practices of banks and other financial institutions and their roles in the economies of different countries, the growth of Islamic banking is a natural development in the context of the present day widespread yearning in Muslim countries to restructure their economic system in accordance with the principles of *Shariah*. However, keeping in view the sway of interest-based banking over a large part of the globe, this indeed is a challenging task which needs to be approached with due caution and careful planning. After living with interest based system for centuries, Islamic banks in a number of countries have just made a beginning to work with new techniques of financing like *mudarabah* and *shirkah*. Though the track record of Islamic banking has been quite good so far, some misgivings are often expressed about the viability of Islamic banking and the likely economic consequences of replacement of interest by a system of profit/loss sharing.[11]

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10. See R.W. Richardson, "Non-Conventional Methods of Financing" in *Development Banking in the 1980s* (United Nations Industrial Development Organisation, 1980), pp.102-104

11. See "Some Misgivings About Islamic Interest Free Banking", text of a lecture delivered by the author in the Annual Lecture Series of Faisal Islamic Bank of Sudan at Khartoum in November, 1985.

A major misgiving about Islamic erest free banking is that the commitment of Islamic banks to share in losses also exposes them to large losses which can lead to their failure and insolvency. This misgiving has no soid foundation. Islamic banks are expected to operate on the basis of a diversified investment portfolio so that notwithstanding losses suffered in some individual cases the overall profitability is well maintained on account of the pooling of risks. Losses tc banks arise mainly on account of defaults on the part of concerns to whom finance is provided. There is no intrinsic reason why an Islamic bank should experience more defaults in the fulfilment of contractual obligations on the part of its clientele compared to other banks. There are three main elements which are germane to the possibility of defaults viz., the nature of the party to whom finance is provided, the purpose for which finance is provided and the type of supervision exercised by the bank on the end-use of funds. These elements are essentially the same for an Islamic bank and a traditional bank, and if sufficient care is not exercised in regard to these elements, defaults would arise irrespective of whether the bank concerned follows the traditional banking practices or the principles of Islamic banking. Given prudent management, there is no reason to believe that the inciuence of defaults would be greater in the case of Islamic banks compared to other banks. On the contrary one should expect that the incidence of defaults would be less because, on account of their having a direct stake in the profits of concerns to whom finance is provided, Islamic banks would be more vigilant in monitoring the end-use of funds as compared to the traditional banks which attach greater importance to the security pledged against the loans compared to the actual monitoring of the business dealings of their clientele.

Another apprehension that is often expressed is that Islamic banks will experience frequent defaults and loss in their earnings on account concealment of correct income by their clients which will undermine their stability. Concealment of correct income for purpose of defrauding a bank working on the Islamic principle

of profit/loss sharing would be an aberration in a society permeated with the Islamic moral values of truth and honesty. However, in actual fact, the state of morality in present day Muslim societies falls much short of the Islamic ideals. Care would, therefore, have to be taken to ensure that the success of Islamic banking is not jeopardised by a tendency on the part of some of the clientele to conceal the correct income and profits. Several writers have pointed out that non-disclosure of correct income on the part of some users of bank funds should not be considered as an insuperable obstacle in the say of successful functioning of the profit/loss sharing system.[12] The intensity of the problem would go on diminishing on its own as the Islamic banking takes its root. Once the system is fully established the users of bank funds would realise that unless the banks are satisfied about the authenticity of their declared income, their access to financial assistance from the banking system is likely to be adversely affected which would not be in their own interest. It has also been pointed out that in cases where the non-disclosure of correct income is due to the complexity of the tax system, corruption in the tax collecting machinery and weaknesses of the auditing system, appropriate changes in the tax and auditing systems would help in overcoming the problem.

It is also pointed out that Islamic banking cannot be practised on an economy wide basis because profit/loss sharing, which is the essence of Islamic banking, is impracticable in cases where, on account of illiteracy or other factors, written records of transactions and accounts are not maintained. There is no doubt that lack of written record of transactions can present problems in the application of the principle of profit/loss sharing. However, this difficulty should not be exaggerated. Outside help can be obtained for maintenance of accounts by parties who are not in a position to do the accounting themselves.

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12. For observations on this subject see M.N. Siddiqi, Issues in Islamic Banking (The Islamic Foundation, U.K.1983) pp.63-64, M.U. Chapra, Towards a Just Monetary System (The Islamic Foundation, U.K., 1985) p.127 and Report of the Council of Islamic Ideology, op. cit., Chapter 1.

Finance can also be made available on the basis of expected rate of profit which is considered "normal" for a particular trade or industry with the provision that bank would be prepared to accept a lower figure of profitability or even share in loss in case convincing evidence is produced to substantiate the deviation of actual profit from the expected normal range of profit. In sectors which are characterised by very low productivity, finance can be provided in the form of interest free loans. A service charge, based on actual charges incurred on administering the loan accounts, is also permissible. Resort can also be taken to certain other methods of financing which are permissible in Shariah such as Bai-Salam, Ijara and Ijara wa iqtina, Bai Muajjal and Murabahah. With such a wide range of financing devices available to Islamic banks, there is no basis for skepticism about the feasibility of putting Islamic banking into practice on an economy wide basis.[13] In fact, interest free banking has already been introduced on an economic wide basis in Pakistan and Iran.

Although the misgivings generally expressed about Islamic interest free banking are not well founded, it is necessary that proper care be exercised in the conduct of Islamic banking to get the best results. It goes without saying that the success of any new endeavour is conditioned by its proper planning and the mode of its execution. The task before the Islamic bankers is a gigantic one. They have to establish a new pattern of banking which is radically different from

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13. Several writers have emphasised that though Islamic banks can make use of a large variety of financing devices permitted under Shariah, resort to devices other than profit/loss sharing and Qard Hasanah (interest free loans) should be limited to situations of inescapable necessity. It has been pointed out that a widespread and indiscriminate use of the other devices would amount to a superficial rather than a real change and would be of no material value in furthering the achievement of Islamic socio-economic objectives. This point was dealt with at length in the Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy submitted to the Government of Pakistan in 1980. See also the author's "Concept and Models of Islamic Banking: An Assessment", op.cit. and Muhammad Nejatullah Siddiqi) Issues in Islamic Banking, op.cit.

traditional banking. The degrees of freedom in fashioning the new system are also limited because all the techniques employed have to conform to Shariah. Because of the ideological character of Islamic banking it is necessary that personnel of Islamic banks should have adequate knowledge about Islam in general and about Islamic edicts and norms relating to business and finance in particular. It is not expected that persons working in Islamic banks would be experts in Shariah. However, they should have adequate knowledge about the fundamental principles of Islam and their application in the ordinary business of life. The training programmes organised for the personnel of Islamic banks should pay special attention to this aspect.

On the technical side, the training programmes should provide detailed guidance to the trainees in respect of the various modes of financing permissible under Shariah. This training should preferably be carried out with the help of a Banking Manual which should assemble all the relevant information about the various modes of financing at one place. The contents of the Manual should be prepared in consultation with scholars well versed in Fiqh literature on the subject so that the actual operating procedures conform fully to the requirements of Shariah.

Since profit/loss sharing is the essence of Islamic banking, the training courses should devote special attention to equipping the trainees with necessary expertise in this field. Intensive training should be given in the techniques of project appraisal, making use of projected financial statements, sensitivity analysis and internal rate of return etc. Special emphasis should be given to methods of monitoring the progress of various projects. Since,unlike the traditional banks, the return on the finances provided by an Islamic bank under profit/loss sharing system depends on the actual operating results of various business enterprises, it is of great importance that a continuing appraisal is made of the working of such enterprises. The monitoring system should be designed to detect

early signs of any trouble that may be brewing in the affairs of any business enterprise to whom funds have been provided by the bank. This would be of help in devising appropriate strategy to remedy the weaknesses and restore the profitability of such enterprises to the mutual benefit of both the parties.

The top management of Islamic banks carries a specially heavy responsibility in the present nascent stage of development of Islamic banking. They have to be men of character, integrity and competence with full dedication to the cause of the advancement of Islamic banking and a determination to establish the new system as a fully viable alternative to the traditional interest based system.

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