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RESEARCH PAPER

on

ISLAMIC BANKING EFFORTS MADE SO FAR

BY

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EXECUTIVE SUMMARY

1. This paper is inspired by the following important considerations:-
   
   i. A famous Hadith says, One must like for one’s brethrens that one likes for one’s self.
   
   ii. Muslim countries in particular, and the rest of the world in general, has been a host to prevalent interest-based financial system that promotes the concentration of wealth in few selected hands.
   
   iii. The wide conceptual gap between shari’ah experts and modern scholars needs to be bridged by presenting the Islamic argument in language which is easily understood by both classes.
   
   iv. The argument must be presented in such a way that the reader can relate them to shariah as well as to modern commerce.

2. First chapter gives summaries of Elimination of Riba from the Economy (Council of Islamic Ideology 1980) and Report on Banks and Financial Institutions (Commission for Islamization of Economy, June 06, 1992). It also gives a historical background and constitutional provisions for devising and implementing Islamic economic system.

3. In chapter two effort is made to discuss the basic definitional concepts of Riba, its prohibition and its various classifications. The foundation given in the Quran and Hadith regarding riba and traditions followed by Arabs at the time of prophet (SAAW) are also contained in chapt.2.

4. In chapter three, Islamic modes of financing are described, which are broadly of nine types as commonly used in present day Islamic banking. Three of these are explained in some details in this chapter.

5. The features of a conventional (non-islamic) bank and the basic functions which it performs are given, followed by the paradigms of Islamic banking to handle these accounts under the Shariyah. It also gives role of the bank
as an agent and guarantor. This chapter explains the Musharahah from of finance and describes different ways to handle it in present system.

6. The root argument for modern banking operations is built on the following premise:

\textit{What is permitted for an individual is also permitted for the banks (that are groups of individuals- share holders) unless there are reasons to conclude other wise.}

The foundation for modern banking operations in the Shariah framework are defined in term of trade-leasing –and partnership-based arrangements and collaterals (rehn) and guarantees. The following options are proposed to be initially made available for the banking system.

\begin{itemize}
  \item Trade-related modes- Bai’Mu’aijil
  \hphantom{.} Bai’ Salam
  \item Leasing modes Ijarah
  \item Partnership modes- Modarabahah and Musharabah
  \item Lending- Qard (Loan)
\end{itemize}
CHAPTER - 1

ISLAMIC BANKING: EFFORTS MADE SO FAR

INTRODUCTION

Today the world economic system, that is based on interest has resulted in concentrating the wealth in the hands of selected few, creating monopolies and widening the gap between the rich and the poor. In contrast Islam encourages circulation of wealth and regards its role as important to an economy as the flow of blood to our human body. Just as clotting of blood paralyzes economy. Economic justice requires a viable economic system supported by an efficient banking system. The rationale of the prohibition of interest cannot be fully understood unless it is viewed in the context of the basic features of an Islamic Economic system. All the persons should be ensured at least the minimum needed for survival in the society. The concentration of wealth in a few hand should be prevented.

The effort should be made so that wealth is kept in circulation for productive purposes. The economic system should keep all the members of the Islamic society actively involved and no body should be left idle except naturally handicapped and voluntarily unemployed. The concept of Islamic economy is perfectly in line with the basic philosophy and its general scheme of life. It aims at the promotion of welfare of both the individual as well as of society. It neither encroaches upon the rights of individuals nor does it endanger the good of the society.

Keeping in view the clear Quranic injunctions regarding elimination of riba it becomes the bounded duty of Islamic State. Pakistan being an ideological state, the adoption of Islamic monetary system has from the very beginning occupied a very important place in this Islamic society.

1. INTEREST FREE BANKING IN PAKISTAN

A HISTORICAL REVIEW

The need for elimination of Ribba from the economy and ordering Pakistan’s economic life according to the teachings of Islam was voiced by experts soon after independence in 1947. On the occasion of the opening of the State Bank of Pakistan on July 1, 1948 Mr. Zahid Hussain the first Government
of subjected to careful scrutiny on scientific lines by competent economists well acquainted also declared that
the research organization established by the State Bank would devote special and unremitting analysis of this
most important aspect of our ideological problem.

In reply to those remarks the father of the Nation, Quaid-e-Azam Mohammad Ali Jinnah said that he would
watch with keen interest the work of the research organization in evolving banking restricts compatible with
Islamic ideas of social and economic life and that the adoption of Western economic theory and practice would
not help us in achieving our goal of creating a happy and contented people. The Quaid-e-Azam also wanted to
present to the world an economic system based on true Islamic concept of equality of man and social justice.

1.1 COUNCIL OF ISLAMIC IDEOLOGY

Inspite of early interest shown in the problems of devising and implementing an economic system based on
Islam no significant developments took place until 1977 when the President of Pakistan announced that Council
of Islamic Ideology should prepare a plan so that interest can be eliminated from the economy with 3 years. The
council of Islamic Ideology then set up a panel of 15 economists and bankers with Dr. Ihsan Rashid as
Chairman, to suggest ways and means of remodelling the economic and financial suggest ways and means of
remodelling the economic and financial system of the country in accordance with the injunctions of Islam.

1.2 ISLAMIC COUNCIL OF IDEOLOGY REPORT 1980

The panel of experts submitted its report to the Council of Islamic Ideology in February 1980 and after
considering the suggestions given in their report the Council of Islamic Ideology gave its formal report to the
Government in June 1980. This was indeed a pioneering effort. It laid down the guidelines for the reorientation
of financing operations of commercial banks in the country in such a way that the system would be in
accordance with the tenets of Islam. The Report included the following main points:-

(i ) It observed that elimination of interest occupies the key position in the establishment of the Islamic
order and the system of Islam and, therefore, it cannot be expected to suggested that other reformatory
measures will have to be undertaken to bring desired results.

( ii ) In view of ensuing for the success of the new system the government will have to carry a thorough
appraisal and reform of the tax system.
(iii) The report stated also that ideally the real alternative to the interest under an Islamic system are profit/loss sharing or Qarz-e-Hasna i.e. Loaning without additional charge over and above the principal amount.

(iv) The other methods of non-interest banking suggested were:

a. Service Charge  
b. Indexation of Bank Deposits  
c. Leasing  
d. Investment Auctioning  
e. Bai Muajjal  
f. Hire Purchase  
g. Financing on the basis of normal rate of return.  
h. Multiple counter Loans et.  
i. Special Loan facility.

(v) The report also expressed strong opposition to setting up of a model bank based on non-Interest Banking and proposed a phased transformation of the entire interest based system into an Islamic Banking system.

(vi) The report gave detailed suggestions both in respect of commercial banks and specialised financial institutions such as PICIC, NDFC, ADBP, Equity Participation Fund, Federal Bank of Co-operatives (FBC), Insurance Companies and Small Business Finance Corporation (SBFC).

(vii) Furthermore chapters on Central Banking and Monetary Policy and government transactions were also included in the report.

1.3 IMPLEMENTATION

So far as the implementation of non-Interest Banking system was concerned a gradual progressive method was adopted.

(i) First Step (July 1979)
Operations of National Investment trust (NIT), Investment Corporation of Pakistan (ICP) and House Building Finance Corporation (HBFC) were rescheduled on a non-interest based system.

(ii) Second Step (January 1, 1981)

A system of profit and loss Sharing (PLS) saving accounts was introduced. Interest free counters were opened at all branches of commercial banks. It was announced that from the aforementioned date the deposits received in PLS accounts will not be used by the Commercial banks in interest earning operations and that these deposits will be maintained separately and used for advances on the basis of interest free system.

(iii) Third Step (July, August 1981)

In August 1981 the commercial banks were allowed to provide finance ranging from Rs. 1,50,000. to Rs. 3,00,000 for house building purposes on a rent sharing basis. Earlier in July 1981 Nationalised Commercial Banks under the leadership of Bankers Equity Limited and ICP undertook consortium financing under participation term certificates arrangements on the basis of discounting lending agencies, pool their resources together to provide loans to a borrowing agency. The participation term certificate replaced debentures for long and medium term loans in local currency. The system of allowing free of charge loans to students as Qarz-e-Hasna were allowed. The students, under the provisions of Qarz-e-Hasna were required to return the principal amount only after completion of education and gainful employment.

(iv) Fourth Step (January 1, 1982)

The system of House Building Finance on rent sharing basis was introduced by commercial banks.

(v) Fifth Step (January 1, 1983)

Hire Purchase financing scheme on rent sharing basis was introduced.

(vi) Sixth Step (July 1, 1984)

All banking companies were allowed to make finances available in any of the 12 modes of financing allowed by the State Bank. (These will be discussed at a later stage). However, as a transitional arrangement, they were also free to lend on the basis of interest, provided that no accommodation for working capital would be provided or renewed on interest basis for a period of more than six months.

(vii) Seventh Step (January 1, 1985)
From the aforementioned date all finances, provided by Banking Companies to federal and provincial governments, public sector corporations and public or private sector and joint stock companies, were to be extended only in one of the 12 non-interest modes prescribed by the State Bank of Pakistan.

(viii) Eighth Step (April, 1985)

All finances provided by Banking Companies to all entities including individuals were changed to no-Interest system as contended in the 12 prescribed modes.

(ix) Ninth Step (July, 1985)

From this date onward the banks were prohibited from accepting any interest bearing deposits.

1.4 Some points about the CII Report that warrant a review of the subject are as follows:

i. The report does not address at length the concept of riba and the Shari’ah requirements for various modes of transactions

ii. The system is emphasizing on rectifying the existing practices rather than identifying a new course of action.

iii. The important issue of financing the budgetary deficit in the absence of riba has not been given due attention.

iv. The areas of international transactions and existing riba-based transactions have not been touched upon in the report.

v. The action plan proposed for transition to a riba-free economy is both incomplete and too brief on some much needed details.

REPORT OF THE COMMISSION FOR ISLAMIZATION OF ECONOMY

1.5 The Commission for Islamization of Economy (CIE) was established by the Government of Pakistan in 1991. Its terms of reference include, among other things, examining banking and insurance laws, practices and procedures and recommending such measures to the Government as would ensure total elimination of riba from the economy.

1.6 In June 1992, the CIE submitted its report. The report focuses on the commercial banking system, and its twelve signatories include the Governor of the State Bank of Pakistan Chairman, one renowned Shari’ah scholar, three politicians, one senior advocate of the Supreme Court of Pakistan, one retired civil servant, two economist, one chartered accountant and two reputed bankers one of whom also acted as Secretary of the
Commission. Five of these members also made significant contributions to the aforementioned Report of the Council of Islamic ideology.

1.7 The Recommended Strategy for Islamization of the Banking System is not about the approach or line of action for the elimination of riba from the banking system or the economy as a whole. Instead, it focuses on the causes of lack of popularity of musharakah as a financing mode and suggests some measures to rectify the situation. The ten listed causes range from lack of information and motivation to lack of a proper legal framework and affirmative policy action in favour of musharakah as a mode of financing. The proposed strategy is equally general, and implies taking of steps for mass awareness, training of bank staff, reinforcement of the system of corporate audit, replacement of fixed interest-based government borrowings with a system based on profit and loss sharing, and so on.

1.8 The Recommended strategy for Islamization of the banking system lists several steps to be taken but, surprisingly with no line of action. It seems that the smooth transition to a riba-free banking system from a target date is taken for granted. The fate of the past attempts at Islamization of the banking system suggests that this may not necessarily be so. Incidentally, it may be noted that the recommended strategy is also silent about the necessary action in lieu of the existing riba-based debts.

1.9 The foregoing discussions underline the need for a fresh attempt in order to explicate the foundations of the Islamic financial system and its practical details keeping in view contemporary needs in the areas of banking, government transaction, and strategy for the elimination of riba.

THE ISLAMIC ECONOMIC SYSTEM

The economic system in capitalism is based on interest and has been flourishing in non-Islamic societies. There are two participants in such transactions one is the investor who provides capital on loan and other Manager who runs the business. The investor has no concern whether the business runs into profit or loss, he gets an (interest) Riba at fixed rate of his capital. This kind of transaction has been prohibited in Islam, In Quran and teaching of Holy Prophet(SAW) Riba has been stopped not through teaching but by making the prohibition law of the land. The subject regarding Riba needs to be addressed in more detail, keeping in view severe warnings contained in the Quran, and Sunnah, as Riba has become an integral part of our economy. Matter seems to be infested with difficulties and has to be carefully examined from all angles. The first step is to deliberate into the correct interpretation of Quranic verses and what has been said in authentic Ahadith, regarding Riba as to
what transactions it covers, what is the underlying wisdom behind its prohibition, and what sort of harm it brings to society. For this purpose the following three factors will help us in understanding the concept.

1. Islamic philosophy
2. Distribution of wealth.
3. Islamic perspective of distribution of wealth.

Islamic Philosophy

There is no concept of Riba in Islamic economic philosophy, because it is that curse which results in accumulating money in the hands of selected resulting in creating selfishness, greed, monopolies, injustice and oppression. Where as Islam encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, as universal brotherhood, Islam does not allow any kind of such Riba based transaction and declares them “Haram”.

Distribution of Wealth

The most important and controversial subject of a man is economic need in our fast moving and expanding world. If the guidance from the creator is not sought it will give rise to multi-directional problems, because of limited and short sighted vision, and limited exposure to fast growing human needs.

Islamic Perspective of Distribution of Wealth

The aim is to clearly and briefly explain the Islamic point of view as given in Quran, Sunnah of Prophet (PBUH) and scholars of Islam regarding distribution of wealth. The basic point of view of which is derived from Quran, regarding Islamic economic system and its difference from non-Islamic system of economics.

(a) The importance of the economic goals.

Islam describes a balanced way of life in which economic activities of a man have a lot of importance towards making the basic needs of his family and all those having right in his earning though it is not the only purpose for which a man has been made responsible, for this economic activity and progress is not the ultimate aim of a human life. Even common sense can suffice to show that the fact of an activity being lawful and necessary, separate from it being the ultimate goal of human life and the center of thought and action. So it is essential to make economics as clear as possible at the very outset. The basic difference between Islamic economics and materialistic economics is, that according to materialistic approach, “Livelihood is the fundamental problem of man and economic developments are the ultimate end of human life” while according to Islamic economics.
“Livelihood may be necessary and indispensable, but cannot be the true purpose of human life” So, Islam guides man to follow the balanced path which leads to the ultimate happiness. All the material world put together has been designated as “Al-Dunya” which does not have a pleasant connotation.

If however, one has to put the Quranic view regarding the livelihood in this world it would not restrict to a few stages of a man’s journey, and his ultimate destination lies beyond them. The destination is sublimity of character and conduct, and consequently, the felicity of the other world. The real problems of man and the fundamental purpose of his life is the attainment of these two-goals. But one cannot attain them without traversing the path of this world. So all those things which are necessary for his worldly life, became essential for man. So long as the means of livelihood are used as path leading towards final destinations, they are the benevolence of Allah, but as soon as man gets lost in the mazes of this pathway and allows himself to forget his real destination, the very same means of livelihood turns into a “trial”

“And know that your possessions and your children are but a trial” 8:28.

At another place Allah has advised very precisely in a brief verse.

“Seek the other world by means of what Allah has bestowed upon you” (28:77).

This principle and attitude of the Holy Quran towards the “economic activity” of man and its two aspects would be very helpful in solving our problems?

2. The Real Nature of wealth and Property, the fundamental principle, which helps to solve the problem of the distribution of wealth, is the concept of “wealth” in Islam. The basic concept regarding wealth, in all its possible forms is that it is a thing created by Allah, and is in principle His “Property”. The right of property is delegated to man it has been advised by Allah.

“Give to them from the property of Allah which He has bestowed upon you.”

(24:33)

The reason for this philosophy is that all a man can do is to invest his labour into a process of production. The man can only sow the seed in the soil, and then leave it to Allah Almighty for the tree to bring fruit. “Have you considered what you till? Is it you yourself who make it grow, or is it We who make it grow?”

It is clearly understood from the above verses of Quran that “wealth” no matter what its form, is in principle the property of Allah, and it is He who bestowed upon man the right to use or exploit it. So it is He who has the right to its expenditure in accordance with His commandments. So the right of property is not absolute but it carries along with it certain limitations and restrictions, which have been imposed by the real Owner of the wealth. So it should be spent according to His command. “Seek the other world by means what Allah has bestowed upon you, and do not be negligent about your share in this world. And do good as Allah
has done good to you, and do not seek to spread disorder on the earth” (28:77) The following guide line is obvious from the aforementioned above verses:

1. Whatever wealth man does possess has been received from Allah.
2. Man has to use it in such a way that his ultimate purpose should be the other world.
3. Since wealth has been received from Allah, so its exploitation must be subject to the commandment of Allah.
4. Allah has done good to you, so we may command you to do good to others. He may forbid you to use this wealth in a specific way, which is likely to produce collective ill for society.

The above mentioned guide line put forward the difference between Islamic point of view from capitalist and socialist points of view. Capitalism gives absolute right of property and allows man to use it as he likes, whereas Holy Quran describes the property of man “as the property of Allah” thus cutting the root of capitalistic approach. But at the same time, by adding the qualification “What Allah has bestowed upon you” it has cut the roots of socialism as well, which starts by denying man’s right of private property, which is in fact a gift from Allah.

**Factors of Production in Islam.**

The Islamic point of view is different from capitalist and socialist point of view. The theory can be understood easily that is to say wealth should be distributed only over those who have taken a part in producing it where as Islam does include the share of those who have not taken direct part in the process of production.

**Islamic Theory**

The factors of production in Islam are three as compared to the other two systems who have four factors and their share is defined, infact those two are quite distinct from Islamic system of economic. Let us have a look at the factors of production.

1. Capital: That is, those means of production which cannot be used in the process of production untill and unless during this process they are either wholly consumed or completely altered in form and which, therefore, cannot be let or leased (for example, Liquid money or food stuff etc.)
2. Land: That is, those means of production, which are so used in the process of production that their original and external form remains unaltered and which can hence be let or leased (for example, land houses, machines etc.)
3. Labour: That is, human exertion, whether of the bodily organs or of the mind or of the heart. This exertion thus includes organization and planning too.
Islam and Capitalism

It will be essential to understand fully the differences that exist, between the Islamic view of distribution of wealth and the capitalist point of view.

1. The Organization have be excluded from the factors of production, and only three factors have been recognized, instead of four. The existence has not been denied but it is included in any of the three factors.

2. It is not “interest” but “Profit” that has been considered as the “reward” for capital.

3. The factors of production have been defined in a different manner Capitalism defines Capital as the produced means of production, like machinery etc as well, beside money and food stuff. But this differs from Islamic definition which cannot be let or leased for example money. Machinery is to be excluded from capital according to this definition.

4. In the same way land has been defined in a more general way. Hence machinery too falls under this Category.

5. The definition of labor too has been generalized so as to include mental labor and planning.

In capitalist system the most important characteristics of the entrepreneur is supposed to bear the risk of profit and loss in his business on the other hand, the Islamic point of view insists that no other factor should be made to bear the burden of this risk.

Now there are three ways in which capital can be invested in a business venture.

1. **Private business**.

   The man who invests capital may run the business himself without the help of any partner. In this case the return which he gets may be called “Profit” from legal point of view.

2. **Partnerships**.

   The second form of investment is that several persons may jointly invest capital, jointly manage the business and jointly bear the risk of profit and loss. This is also called “Shirkat-ul-Aqd”

3. **Co-operation of capital and organization (Mudarabah)**.

   The third form of investment is that one person may invest capital while another may manage the business, and each may have a share in the profit. But if the person who has been managing the business eventually suffers a loss in the business, his labor will go wasted as the capital of the investor would go wasted.

**Money Lending Business**

The fourth form of investing capital, which has been practiced in non-Islamic societies is the money-lending business where one person lends out capital in the form of a debt, and the second person puts in his labor. If there is a loss it has to be borne by labor and irrespective of profit or loss, interest has to be paid in any case. Islam has forbidden this form of investment.

“O believers, fear Allah, and give up what is still due to you from the interest (usury) if you are true believers” (2:278)
another place in the holy Quran, Allah Almighty warns:
“If you do not do so, then take notice of war from Allah and His Messenger (PBUH), But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it. (2:279)

The Objectives of the Distribution of Wealth in Islam

If we consider the injunction of the Holy Quran, it would appear that the system for distribution of wealth laid down by Islam envisages three objects.

\(\text{a) The establishment of a practicable system of economy}\)

The aim and objective of distribution of wealth is to establish a system of economy which is natural and practicable, allows maximum participation by the individual. This can only be achieved by having healthier relationship between the employer and the employee, and the basic rule of supply and demand.

“We have distributed their livelihood among them in worldly life, and have raised some above others in the matter of social degrees, so that some of them may utilize the services of others in their work” (45:52)

\(\text{b. Enabling every one to get what is rightfully due to him.}\)

The second object of Islamic economic system is to enable everyone to get what is rightfully his. The Islamic concept is that a man can have a right in wealth without having direct participation in the process of production. All those poor, helpless, needy, pauper and destitutes also have a right to wealth.

“In their wealth there is a known right for those who ask for it and those who has need for it. (70:24-25) This right has been the right of Allah. “And pay what is rightfully due to Him on the day of harvesting” (6:142)

\(\text{c. Eradicating the concentration of wealth.}\)

The wealth instead of becoming concentrated in a few hands, should be allowed to circulate in the society as widely as possible, so that the distinction between the rich and poor is reduced as much as possible. Islam denies the monopoly of an individual or group over the primary sources of wealth, but has given an equal right to derive benefit from them. Mines, forests un-owned barren lands, hunting and fishing wild grass, rivers, spoils of war etc are primary sources of wealth.

“So that this wealth should not become confined only to the rich amongst you” (59-7)

Islam does recognizes the man’s right of property once his resources and labor have been utilized.

“We have distributed there livelihood among them in worldly life, and have raised some above others in the matter of social degrees, so that some of them may utilize the services of others in their work.” (43:32)

Keeping these three objects of distribution of wealth the first distinguishes Islamic economy from socialism the third from capitalism, and the second from both at the same time.
CHAPTER – 2

2.1 RIBA AND ITS TYPES

The word “Riba” means excess, increase or addition, which correctly interpreted according to shariah terminology implies any excess compensation without due consideration. This definition is derived from Quran and is accepted by Islamic scholars. There are two types of Riba, Identified to date by these scholars. namely Riba An Nisiyah and ‘Riba Al Fadl’

Since the first type was specified in Quranic verses before the saying of Holy Prophet (SAAW) this type was known as Riba al Quran. However the second type is understood with the help of Hadees so it is call Riba al- Hadees.

2.2 Riba An Nasiyah

“O those who believe, fear Allah and give up what still remains of the Riba if you are believers. But if you do not do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the right of the return of your capital; neither will you do wrong nor will you be wronged (2:278-9) At another place in Holy Quran Allah warns.

“ Seized in this state they say: Buying and selling is but a kind of interest even though Allah has made buying and selling lawful, and interest unlawful” (2:275)

Imam Abu Bakr Hassas Razi has defined probition of Riba in the following words.

“That kind of loan where specified repayment period an amount in excess of capital is predetermined”.

In another Hadees it is said “Every loan that draws interest is Riba”

2.3 Riba Al Fadl

Riba Al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to hand purchase & sale as explained in the famous hadith.

The Prophet(PBUH) said, “Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt for salt, sell barley for barley but if a person transacts in excess, it will be usury (Riba)
2.4 **Riba in the Quran**

Allah has commanded Muslims to stay away from this evil and do not let it flourish in the Muslim society.

1. That which you give an interest to increase the peoples wealth increase not with God, but that which you give in charity, seeking the goodwill of God, multiplies manifold.” (30:39).

2. Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil, this is because they say: Trade is like interest’ while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desists, may keep their previous gains, their case being entrusted to God, but those who revert shall be the inhabitants of the fire and abide therein for ever” 275( al-Baqarah)

“And fear the Day when you shall be returned to the Lord and every soul shall be paid in full what it has earned and no one shall be wronged”

(281-al-Baqarah)

2.5 **Riba in Hadith**

1. From Jabir “The prophet may cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said” they are all a like (in guilt) (Muslim, Tirmidhi and Musnad Ahmad)

2. Jabir Ibn Abdallah” giving a report on the Prophets Farewell Pilgrimage, said; The Prophet, addressed the people and said “All the Riba of Jahiliyyah is annulled. The first Riba I annul is our Riba, that accruing to “Abass Ibn al-Mattalib ( the Prophet’s uncle) it is being cancelled completely.( Muslim also in Musnad Ahmed)

3. From Abu Hurayrah. The Prophet said.” There will certaing come a time for mankind when everyone will take riba and if he does not do so, its dust will reach him” (Abu Dawud, Ibn Majah)

**Riba an Nasiyah**

1. From Usman Ibn Zayd . The Prophet, said: There is no Riba except in Nasiyah [Waiting]” (Bukari, Muslim and Musnad Ahmad) “ There is no riba in hand-to-hand (spot) transactions” (Muslim and Nasa-i)

2. From Anas ibn Malik. The prophet said. “when one of you grants a loan and the borrower offers him a dish, he should not accept it, and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually” (Sunan al-Bayhaqi)
Riba al Fadl

1. From Umar ibn al-Khattab. The last verse to be revealed was on riba and the Prophet, was taken without explaining it to us) so give up not only riba but also raibah (What ever raises doubt in the mind about its rightfulness) (ibn Majah)

2. From Abu Said al-Khudri. The Prophet said: Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, and hand to hand. Whoever pays more or takes more has indulged in riba. The taker and giver are alike (in guilt) (Muslim, Musnad Ahmed)

CHAPTER -3

ISLAMIC MODES OF FINANCING

In this part of the paper I would like to give the basic definition of all the types of different modes of financing and explain only three which can be taken in detail and their application in Islamic banking system.

1. Musharakah (Profit and Loss Sharing)
2. Mudarabah (Business Financing)
3. Murabaha
4. Diminishing Musharakah (House /Transport Financing)
5. Salam (Advance for Agriculture)
6. Istisna (Project Financing)
7. Istitrar
8. Ijarah (Leasing)
9. Ijarah wa Iqtina (Leasing and Promise to Gift)

3.1. MUSHARAKAH

Now let us have a detailed view of Islamic modes of financing and their applications in Islamic banking system according to shariah rules. Allah has declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust.
**Definition and Classification of Musharakah.**

The literal meaning of Musharakah is sharing. The root of the word “Musharakah” in Arabic is Shirkah, which means being a partner. A joint enterprise farmed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. It is an ideal alternative for the interest based financing with for reaching effects on both production and distribution. It is divided into kinds.

1. **Shirkat-ul-milk (Partnership by joint ownership)**

   It means joint ownership of two or more persons in a particular property. This can come into existence in two different ways.
   
   (a) **Optional (Ikhtiari).** At the option of the parties e.g. if two or more persons purchase equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called shirkat-ul-Milk Ikhtiari.
   
   (b) **Compulsory (Ghair Ikhtiari).** This comes into operation automatically without any effort/action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.

   There are two more types of joint ownership.
   - **Shirkat-ul-Ain**
   - **Shirkat-ul-Dain**

   A property is jointly owned but not divided yet, is called Musha. This can be used in the following manner.
   
   a) **Mushtarik Intifa.** Mutually or jointly using an asset by taking turns under circumstances where partners or joint owners are on good terms.
   
   b) **Muhaya :** In this arrangement the owner will set turns in days, for example one may use it for 15 days and the other for the rest of the month.
   
   c) **Taqseem:** In case the asset can be divided like a piece of land which can be equally divided into two for making a house.

2. **Shirkat-ul-Aqd (Partnership by contract).**

   This can be understood as joint commercial enterprise. It is further divided into three parts.
i) Shirkat-ul-Amwal (Partnership in Capital). Where all the partners invest some capital into a commercial enterprise.

ii) Shirkat-ul-Aamal (partnership in services), where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio.

iii) Shirkat-ul-Wujooh (partnership in good will). The word has its root in Arabic word wajahat meaning good will. Here the partners have no investment at all. They purchase commodities on deferred price, by getting Capital as loan because of their good will and sell them on spot. The profit so earned it distributed between them at an agreed ratio.

3. The basic rules of Musharakah.

The capital in a Musharakah agreement should be.

a) Quantified (Ma. Loom): Meaning how much.

b) Specified (Muta, aiyan) : Meaning specified currency.

c) Not necessarily be merged: The mixing of Capital is not required.

d) Not necessarily be in liquid form: Capital share may be contributed either in cash/liquid or in the form of commodities. The market value will determine the share of the partner in the capital.

4. The uses of Musharakah are given as Appendix -1

3.2 MUDARABAH

This is a kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner who is called Rab-ul-Maal” while the management and work is an exclusive responsibility of the other, who is called “Mudarib” and the profits generated are shared in a predetermined ratio.

1. Types of Mudarabah.

There are two types at Mudarabah namely.
1. **Al Mudarabah Al Muqayyadah:**

Rab-ul-Maal may specify a particular business or a particular place for the mudarib, in which case he shall invest the money in that particular business or place. This is called restricted Mudarabadh.

1. **Al Mudarahbah al Matlaqah:**

However if Rab-ul-Maal gives full freedom to Mudarib to undertake whatever business he deems fit, this is called unrestricted Mudarabah. However Mudarib Cannot without the consent of Rab-ul-Maal lend money to anyone. Mudarib is authorized to do anything, which is normally done in the course of business. Mudarib cannot do some extraordinary work without the permission of Rab-ul-Maal. He is also not authorized to:

   a) Keep another Mudarib or a partner.
   b) Mix his own investment in that particular Mudarabah without the consent of Rab-ul-Maal.

Conditions of offer and acceptance are applicable to both. A Rab-ul-Maal can contract Mudarabah with more than one person through a single transaction.

**INVESTMENT**

In Mudarabah, Rab-ul-maal provides the investment and Mudarib the management therefore the Rab-ul-Maal should hand over the agreed investment to Mudarib and leaves everything to Mudarib with no interference from his side but he has the authority to oversee the activities with Mudarib’s consents.

4. The uses of Mudarabah are given as Appendix -2

3.3 **MURABAHA**

Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit there on. Thus Murabahah is not a loan given on interest, it is a sale of a commodity for cash/deferred price.

The Bai, Murabahah means the bank purchases a commodity on behalf of a client and resales to its client adding cost plus profit basis. In this manner the bank discloses its cost incurd profit margin to the client. This is as old as Musharakah and today all the Islamic banks World-over 66% of all investments transaction are through Marabahah.
1. **Difference between Murabahah and Sale**

A simple sale in Arabic is called Musawamah a bargaining sale without disclosing or referring to what the cost price is. However when the cost price is disclosed to the client it is called Murabahah. A simple Murabahah is one where there is cash payment and Murabahah Muajjal is one on deferred payment basis.

2. **Basic rules of Murabahah**

Following are the rules governing a Murabahah transactions.

1. The subject of sale must exist at the time of sale.
2. The subject matter should be in the ownership of the seller.
3. The subject matter should be in the ownership of the seller.
4. The sale must be instant and absolute. Thus any sale attributed to a future date or event is void.
5. The subject matter having no value cannot be sold or purchased.
6. The subject of Sale should not be a thing used for an un-Islamic purpose.
7. The subject of sale must be specifically known and identified to the tougher.
8. The delivery of the item sold must be certain and should not depend on any contingency.
9. The certainly of price is a necessary condition for the validity of the sale.
10. The sale must be un-conditional. A conditional sale is invalid unless the condition is recognized as part of the transaction according to the usage of the trade.

3. **Issues in Murabahah**

Following are some of the issues in Murabahah financing.

1. **Securities against Murabahah**

   Payment coming from the sale are receivables and for this, the client may be asked to furnish a security.

2. **Guaranteeing the Murabahad**

   The seller can ask the client to furnish a 3rd party guarantee. In case of default on payment the seller may have recourse to the guarantor who will be liable to pay the amount guaranteed to him.

3. **Penalty of Default**

   In case of any default in payment of the price at the due date the price cannot be changed nor can penal by fees be charged.

4. **Rollover in Murabahah**

   The Murabahah transaction cannot be rolled over for a further period as the old contract ends. This should be understood that it is not a loan rather a sale of the commodity, deferred to a specific date.
5. Rebate on earlier payment
   Some times the debtors want to pay early to get discounts. This is considered un-Islamic but bank can give rebate depends upon clients need.

6. Calculation of cost in Murabahah
   The seller has to ascertain the exact cost of commodity he wants to sell. If the exact cost cannot be ascertained then Murabahah cannot take place.

7. Subject matter of the Sale
   All commodities cannot be the subject matter in Murabahah because certain requirements need to be fulfilled. The shares of a lawful company can be sold or purchased on Murabahah basis because according to the principles of plan the shares represent ownership into assets of the company provided all other conditions of the transaction are fulfilled.

8. The uses of Murabaha are given as Appendix -3

3.4 DIMINISHING MUSHRARAKAH

   This type of Musharakah has developed in recent past, in this a financier and his client participate in a joint ownership of property or an equipment. The client keeps on purchasing the sub units periodically.

3.5 SALAM

   This mode of financing can be used by the modern banks and financial institutions especially to finance the agricultural sector. In Salam, the seller undertakes to supply specific goods to the buyer at a future date in exchange of an advance price fully paid at spot. The price is in cash but the supply of purchased goods is deferred.

3.6 ISTISNA

   Istisna is a sale transaction where a commodity is transacted before it comes into existence. It is an order to manufacturer to manufacture a specific commodity for the purchaser. The manufacturer uses his own material to manufacture the required goods.

3.7 ISTIJRAR

   Istijrar means purchasing goods time to time in different quantities. In Islamic jurisprudence Istijrar is an agreement where a buyer purchases something from time to time, each time there is no offer or acceptance or bargain. There is a master agreement where all terms and conditions are finalized. There are two types of Istijrar. Where by the price is determined after all transactions of purchase are complete. Were by the price is
determined in advance but the purchase in executed from time to time. The first kind is relevant with the Islamic mode of financing.

3.8 IJARAH (LEASING)

Ijarah (hiring), in Arabic Language, from “ajara ujeru” or eijar (renting) or Ujrah (hiring of labor) and cover modern leasing. It is a contract that allows the ownership of a lawful and certain usufruct derived from certain goods or service hired on certain return, renting, being a useful contract of mutual help and cooperation amongst the different members of human society, was in practice since man started living in a community.

3.9 IJARAH WA IQTINA

In Islamic Shariah, it is allowed that instead of Sale the lessor signs a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment at all amounts of rent. It has been allowed by a large number of contemporary scholars and is widely acted upon by the Islamic banks and financial institutions. The validity of this depends on two basic conditions.

a. The agreement of Ijarah itself should not be subjected to signing this promise of sale or gift but the promise should be recorded in a separated document.

b. The Promise should be unilateral and binding on the promise only. It should not be a bilateral promise binding on both parties because in this case it will be a full contract effected to a future date, which is not allowed in the case of sale or gift.
CHAPTER – 4

THE FEATURES OF A CONVENTIONAL BANK

In this part a comparison between the conventional banking which is based on interest with Islamic banking which perform the following major activities is made.

1. Deposit Creation
2. Financing
3. Agency Services
4. Issuing LGs
5. Advisory Services
6. Other related Services.

4.1 Deposits (The Liability Side)

Deposit – gard (Loan) not amanah (Trust)

The common misconception regarding “deposit” is that it is a form of amanah (Security Trust). However according to Shariah definition, deposit has more resemblance to qard (loan) than amanah. Deposits cannot be termed amanah, because it does not have two important features.

1. Amanah cannot be used by the bank for its business or benefit.
2. The bank cannot be liable in case of any emergency circumstances beyond its control. The deposits are placed in banks primarily to earn profit, which is only possible when the bank uses these deposits to invest business. Hence deposits do not fulfill the first condition of amanah, which says that it should not be used for business or benefit.

Secondly, the bank is held fully responsible for these deposits in all circumstances even in case of loss or damage to the bank. This condition puts deposits out from amanah where the assets will not be returned in case of circumstances beyond control so all the three types of deposits fall into the category of qard and are not amanah current account also falls into the category of gard.

The depositors are not interested in terminology but the end result of holding an account. In case the banks do not offer security and consider the assets as amanah, so in case of any loss without the negligence of the bank, assets will not be returned no body will keep his money in this bank. So it is very clear that the money put in banks is not as amanah, but as qard by having collateral security and appointing bank as guarantor.

From above discussion, we conclude that all three types of bank deposits are governed by the law of qard as the depositors may withdraw the assets deposited. Any increase on it will be interest, which is prohibited in Islam just like usury. It is also clear that there is a consensus of Muslim scholars that the transactions in Fixed Deposit and Saving Account is prohibited because the banks pay excess to their account
holders over their actual capital, which is interest. The Islamic Fiqh Academy Jeddah in that 2nd Session has further endorsed such transactions as interest based transaction. Therefore it is illegal for a Muslim to keep his deposits in such accounts. As far as current account is concerned it is allowed because no extra amount is paid on it.

Now let us have a look at the Islamic banking system in which Musharakah can play a very important role. We will discuss now the banks can operate on Musharakah basis. Bank has two sides, one where it receives deposits from customers which is called the liability side and the other where it advances finance to investors and businessmen which is called the asset side. Both sides can operate on Musharakah basis. Through Musharakah money can be received from customers meaning that every depositor will become a partner in banks business through his deposited money.

4.2 Role of the Bank as Agent

A bank under Islamic Shariah can act as an agent of the customer and can carry out the transaction on his behalf. It can also charge agency fee for the services. The agency fee can be charged in the following cress.

- Payment /receiving of cash on behalf of the customer.
- Inward bill of Collection.
- Outward bill of Collection.
- LC opening and acceptance
- Collection of export bills/bills of exchange. Banks will Charge an agency fee for accepting the bill, which is bought at face role.
- Under writing and IPO Services.

4.3 Role of the Bank as Guarantor

The bank of financial institute give a guarantee on behalf of its customer but according to Shariah, guarantee fee cannot be charged, Convention banks charge fee for following reasons.

- Letter of guarantee
- Shipping guarantee

4.4 Advisory Services

Most of the advisory services provided by the financial institutes can be carried out easily in compliance with Shariah as long as the nature of business is hold.

- Financial advisory services
- Privatization advisory services
4.5 MUSHARAKAH IN BANK DEPOSITS

In Islamic banking the account will be different from conventional banks which is based on Musharakah. Participants in joint investment will be called share holders because by a mutual contract they have used their capital and deed in the bank. They will not be the actual shareholders of the bank rather partners in profit only in case they have opened there account in fixed deposited and saving accounts.

The states of the bank will be that of a Mudaraib and the account holder will be Rubb-ul-mal. The contract know as Musharakah wil be a combination of Shirkah and Mudarabah. This is the reason why the profit ratio of depositors is less than the actual shareholders and the depositors will not have any voting power or the right of management because they are not involved in the deed but has only supplied the capital. This kind of dual relationship is not uncommon in Islamic Fiqh.

4.6 DISTRIBUTION OF PROFIT UNDER MUSHARAKAH AGREEMENT

It is important to mention that the profit which an account holders is entitled in case of saving accounts and PLS account will be discussed in the following paragraphs.

It is not a condition for distribution of profit that all assets are in liquid form rather the profit and loss is calculated on the basis of evaluation of assets. In case of loss each partner shall suffer the loss exactly according to there ratio of his investment and in case of profit; the profit will be distributed according to the agreed ratio between the partners. It should be taken into account that both parties are free to determine therefore it can be agreed mutually that Rubb-ul-mal will have a higher profit margin and Mudarib lower. However as a shareholding partner, the share of profit of the Mudarib cannot be less than the ratio of his investment since he is the sole provider of labor. Same rule will apply on the operation of Islamic Banks on the basis of Musharakah.
4.7 MODERN BANKING OPERATIONS.

The conventional banks, mainly commercial banks, have some capital of their own (equity of the shareholders) that is mostly used to provide the infrastructure for banking activities. They almost invariably acquire funds from savers on the basis of interest, and provide those funds to prospective users against interest. They, apart from safe-keeping of valuables, providing funds, collection & transfer services, and verifying credit-worthiness of their clients, the banks also act as pure financial intermediaries that do not get themselves involved in economic activities, such as trading or investment; like economic agents in the economy. Those investment banks that do venture into trading and direct investments, their funds are mostly raised as well as committed on an interest basis.

4.8 SHARI’AH FOUNDATIONS FOR MODERN BANKING OPERATIONS

i. The basic requirement is given in the form of permissible modes of transaction in the Qur’an, the Sunnah and the Fiqah.

ii. In principle, what Allah (SWT) and his Prophet (SAAWS) has permitted, no authority can prohibit. Likewise, what is prohibited by them, no one can legitimize. This has been done for the betterment of mankind. The banks are legal entities that represent the interests of their shareholders. Therefore the Islamic alternatives must be conceived in the broader context of permissible forms of transactions for the banks as groups of individuals. Thus a girding principle for identifying the Islamic course of action in the area of banking will be as follows.

What is permitted for an individual is also permissible for the banks (that are groups of individuals-shareholders) unless there are reasons to conclude otherwise.

The following points need to be kept in view in the case of a riba-based economy seeking transition to a riba-free banking system. The initial list of options that that banks may adopt should be small and, at the same time, reasonably comprehensive to take the most, if not all, the goals being pursued and the functions being performed by them at present. Complete options can be explored and adopted later on. This is essential in order to ensure against Islamization efforts going astray due to lack of clear vision, as happened in 1980s.

The initially chosen options should be simple and readily understandable for all-bank clients and staff. So that educational and training costs of transition can be reduced.

‘Duplication in the options should be avoided as it may confuse matters.’
4.9 Trading-Based Arrangements

Bai’ mu’ajal is the Arabic acronym for “sale on deferred payment basis”. The deferred payment becomes debt against the buyer payable in lump sum or in installments (as per agreement with the seller). In addition to the concurrence of the sale, conditions for a valid bai’ mum’ajjal are as follows.

The price to be paid must be agreed and fixed at the time of the deal. It may include any amount of profit without qualms about riba. Complete/total possession of the thing in question must be given to the buyer, while the deferred price is to be treated as debt against him. Bai’ salam involves advance payment party for delivery of thing in future—a converse of bau’mu’ajjal. It applies to the case in which things come into the possession of the instance, a wholesaler acquiring goods from a manufacturer and supplying them to the retailers. Bai’ salm is a valid transaction with the following three basic conditions:

i. The nature, quality and quantity of the merchandise (to be delivered in future) must be clearly specified along with the delivery date.

ii. The price to be paid in advance should also be fixed.

iii. The transaction should be settled with the delivery of goods, not on the margin.

4.10 Leasing-Based Arrangements

Ijarah or leasing is a contract for the usufruct of an asset while its ownership still remains with the original owner, i.e., the lessor. In this case, the lessor leases his asset to another party, the lessee, against a predetermined rental for a prescribed period. Thus, besides the concurrence of the concerned parties, there are three fundamental conditions for a valid ijarah contract:

i. The asset be the property of the lessor.

ii. The period of contract be specified.

iii. The rental and its payment schedule be precisely stated.

4.11 Partnership-Bases Arrangements

Modarabah and musharakah are two partnership modes that allow two or more parties to share both the contributions to and the fruits of economic activity, albeit in varying degree, through mutually agreed arrangements.

A modarabah between two persons is an extreme case in which one partner (called rabb-ul-mall or owner of Capital) provides capital while the other (called modarib or active partner) his effort or expertise. If both partners contribute to the capital, it becomes a musharakah. The quantum of effort put in by either partner is not
critical in this regard: the arrangement would still be a musharakah even though one of the partners might choose not to put in any effort. If both partners share in effort as well as in equity, the musharakah would correspond to a reciprocal modarabah.

**COLLATERAL (REHN) AND GUARANTEES**

Creditors may seek Collateral to protect their interests. In this regard, the following principles need to be observed.

1. Collateral should not be of the same kind as the object of the loan/debt.
2. Creditors may not draw benefits from the object of collateral.
3. The collateral may be liquidated as per agreement. However, if the liquidation proceeds exceed the quantum of debt, the balance has to be paid to the debtor. Likewise, if the value of liquidated collateral falls below the amount of debt, the balance would stand as unpaid debt against the debtor.

**Conclusion**

The solution to all our economic problems lies in following the system bestowed by Allah almighty through Holy Quran and prophet (SAAW)
The system of Islamic banking has never been in place in modern time and it seems difficult to plug in the gaps that keep on appearing due to lack of any framework in this regard, and due to difference of opinion on interpretation of Islamic injunctions.
Lack of confidence in a new system that is yet to evolve and take root in modern economics is another problem. A system, which has come about after a lot of controversy and modifications to conform to present day requirements of all segments of society at large and small interposes /entrepreneurs is full of controversies.
There is a need to settle the controversies and arrive at a consensus interpretation of the definitions of “Riba” and “Usury”. How this curse (Riba) can be completely eliminated from our financial system should be our main goal. Literacy rate in our country is a major hurdle;
There is a need to educate our society regarding Islamic banking system and its applications in different modes of financing and in modern banking system Conventional banking, which is interest (Riba) based performs certain functions that can be replaced by alternate Islamic forms of transaction based on Shariah.
Due to lack of intellectuals and inputs from different sectors, the institution could not develop to conform to present day requirements. A dialogue should be initiated to arrive at a consensus in evolving a Riba free economy based on modalities acceptable to all schools of Islamic Jurisprudence, as well as modern economists.
**RECOMMENDATIONS**

1. The existing banking system would be transformed into a riba-free system within the same time frame as that needed in any case for a complete switch-over to riba-free banking.

2. First step towards phasing out the present system, there must be an immediate emphasis on the launching of new riba-based products and promotion of the existing ones by the banks.

3. There can be three basic strategies for a solution.

   i. A surgical action that strikes all forms of riba practices immediately and convert over night to Islamic mode.

   ii. Both existing and new Islamic banking co-exist for a certain time and are than gradually replaced with a single Islamic Banking mode.

   iii. A reasonable middle time frame is detained for conversion of the exiting backing into riba free system of there, the first option is too drastic and may have un foreseen consequences which Pakistan limited fiscal space does not allow far.

   The third has been attempted over the last two decades and has not succeeded so far. There seems a little argument to let the practice continue. This leaves as with the 2nd option which is a middle of way and which would appeal to all sensitivities. In such an approach the following would be adopted.

   a. The Government should announce a firm commitment to resolve to the eventual elimination of riba in all forms of banking.

   b. All banks be required to initiate one branch in every major city to be converted into Islamic mode within six months.
4. A coordination committee may be established to work with and beyond these to six month to evolve a practical system with following members.

a. Two member from each commercial banks
b. One representation from each investment bank and Modaraba association.
c. 3 subject specialist from state bank (commercial banking, FE,CBD’s)
d. Two officials from MOF”
e. Two from law dep.
f. One member each from C.A and cost accountant association.
g. One from Banking tribunal
h. One sharia scholar
i. One prof. from Islamic University
j. Two member from past committee
k. Two member from business and industrial association

5. Time Frame

a. As mentioned above, the committee will evolve a system for banking debt, audits, international debt, international transaction and central banking operations within the first six months.
b. In the following one year the committee will monitor the progress of Islamized branches and workout their operational problems.
c. At the end of said 12 months period bank would be required to convert 5 branches in each city to Islamized branches.
d. By end of further 12 months, complete banking should be transformed into Islamic banking system.

6. Money moves the world, which is why even Islam was not established without a financial support (in form of Zakat, Ushar etc). Similarly a new Islamic Banking
system cannot be successful in the first 18 months of its innovative and exploitative stage unless the concept has a financial backing.

It is therefore proposed that each bank be required to contribute a fixed percentage of its book-profits to the proposed Islamization Committee. The amount of this contribution is proposed to be initially at 0.25% of a bank’s profits, with a minimum of Rs. 5 million per annum for the first three years. Thereafter it can be made into a permanent contribution to the Committee of 0.01% of booked profits with a minimum amount of rupees. 500,000 per annum.

Appendix -1

Uses of Musharakah/Mudarabah:

These modes can be used in the following areas (or can replace them according to Shariah rules).

Asset Side Financing

- Short/medium/long-term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Inland bills drawn under inland letters of credit
- Bridge financing
- LC with margin (for Mudarba)
- LC with margin (for Musharakah)
- Export financing (Pre-shipment financing)
- Working capital Financing
- Running accounts financing/short term advances

Liability Side Financing

- For current/saving/mahana amdani/investment accounts (deposit giving Profit based on Musharkah/Mudarbah-with predetermined ratio)
- Inter-Bank lending/borrowing
• Term Finance Certificates & Certificate of Investment
• T-Bill and Federal Investment Bonds/Debenture.
• Securitization for large projects (based on Musharakah)
• Certificate of Investment based on Murabahah (Eg: AI Meezan Riba Free)
• Islamic Musharakah bonds (based on projects requiring large amounts – profit based on the return from the project)

Appendix -2

Uses of Musharakah/Mudarabah:

These modes can be used in the following areas (or can replace them according to Shariah rules).

Asset Side Financing

• Short/medium/long-term financing
• Project financing
• Small & medium enterprises setup financing
• Large enterprise financing
• Import financing
• Inland bills drawn under inland letters of credit
• Bridge financing
• LC with margin (for Mudarba)
• LC with margin (for Musharakah)
• Export financing (Pre-shipment financing)
• Working capital Financing
• Running accounts financing/short term advances

Liability Side Financing

• For current/saving/mahana amdani/investment accounts (deposit giving Profit based on Musharkah/Mudarbah-with predetermined ratio)
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• Islamic Musharakah bonds (based on projects requiring large amounts – profit based on the return from the project)
Uses of Murabahah:

Murabahah can be used in following conditions:

Short/Medium/Long Term Finance for:

- Raw material
- Inventory
- Equipment
- Asset financing
- Import financing
- Export financing (Pre-shipment)
- Consumer goods financing
- House financing
- Vehicle financing
- Land financing
- Shop financing
- PC financing
- Tour package financing
- Education package financing
- All other services that can be sold in the form of package (i.e. services like education, medical etc. as a package)
- Securitization of Murabahah agreement (certificate) is allowed at par value only. Otherwise certain rules of Islamic Finance must be met.
FUNDAMENTAL DIFFERENCES BETWEEN
ISLAMIC AND TRADITIONAL FINANCING PARADIGMS

FOUNDATIONS

The Islamic Paradigm: Financial intermediation is aimed at addressing concerns of depositors and meeting needs of end-users of funds in the framework of permissible forms of transactions in the Shari'ah.

The Traditional Paradigm: Financial intermediation is carried out on the basis of (interest-based) lender-borrower relationships between depositors and banks on one hand and banks and end-users of funds on the other.

ROLE FUNCTIONS OF PLAYERS ON FINANCIAL SCENE

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<td>(i) Lenders</td>
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GUIDE TO DIAGRAMMATIC ILLUSTRATIONS

- Financial flows
  - Return financial flows
  - Real flows (goods/services)
  - Distinguishing features for Islamic Paradigm
  - ▲ for Traditional Paradigm

The sequence of transactions is indicated by (1), (2), (2'), (3) and (4). Simultaneity in transactions process is shown by supplementing the respective transaction number by alphabetic characters, such as (1a) & (1b) and (4a) & (4b). And, two commitments 1 and 2 at the transaction stage (1b) are denoted by (1b.1) and (1b.2).
APPLICATION OF FUNDS

Trading: Bank Client wants to purchase and, thereby, own a good.
(Bai’ Ma’ajid)

Islamic:

Traditional:

Financial flows run parallel to real flows.
Claims of Bank/Obligations of Bank Client are time-invariant.

There is a dichotomy between financing and the use of funds.
Claims of Bank/Obligations of Bank Client are adjustable.
MOBILIZATION OF DEPOSITS

Demand/Interest-Free Deposits:

Islamic: Deposits

Traditional: Deposits

Deposit Carrying a Return:

Islamic: A. Mudarabah Deposits

(1) Profit for Investment

(2) Principal + Share of Profit

B. Musharakah Deposits

(1) Principal + Share in Profit

(2) Principal + Share in Profits

(3) Bank’s Contribution

Traditional: Time/Investment Deposits

(1) Interest-based Loan

(2) Principal + Interest

* In the above case, principal is not guaranteed; losses, if any, are to be shared by all contributors in funds on proportional basis.
* Accounts for different categories of deposits would be maintained separately.
Bank Client is interested in the usufruct of an asset.

**Islamic:**

1. Bank
2. Asset
3. Cash Payment
4. Kerad

**Financial flows are tied to real flows.**
**Claims of Bank/Obligation of Bank Client are time-invariant.**

**Traditional:**

1. Bank
2. Kerad
3. Principal + Interest
4. Unusfruct of Asset

**There is a dichotomy between financing and the use of funds.**
**Claims of Bank/Obligation of Bank Client are adjustable.**
Partnership: Bank Client needs funds for undertaking economic activity—trading (buying and selling), leasing (renting buildings and equipment), hiring labour, etc.

**Islamic:**

A. *Modaraba* Financing

- Bank (4A) Principal + Share in Profit
- Funds (4B) Profit
- *Modaraba* (2) Application of Funds
- Economic Activity (3) Capital + Profit

B. *Musharakah* Financing

- Bank (4A) Principal + Share in Profit
- Funds (4B) Profit
- *Musharakah* (2) Application of Funds
- Economic Activity (3) Capital + Profit

In case of losses, *Modaraba* (*Musharakah*)

- Principal minus Loss
- Principal minus Share in Loss

Bank ip party to the use of Funds—financing and economic activity are inseparable.

**Traditional:**

- Bank (1) Loan
- Bank Client (2) Loan: Capital + Interest
- Economic Activity (3) Capital + Profit

- There is a dichotomy between financing and the use of funds.

- Payment claims in favour of the bank are independent of profits/loss to the client.
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