A CRITICAL STUDY OF MURABAHAH AS AN ISLAMIC MODE OF FINANCING

ABSTRACT
THESIS

SUBMITTED FOR THE AWARD OF THE DEGREE OF

Doctor of Philosophy

IN

ECONOMICS

BY

KHALID WAHEED

UNDER THE SUPERVISION OF

Dr. S.M. JAWED AKHTAR
(READER)

DEPARTMENT OF ECONOMICS
ALIGARH MUSLIM UNIVERSITY
ALIGARH (INDIA)

2008
ABSTRACT

Islamic finance – financial institutions, products and services designed to comply with principles of Shari'ah (Islamic law) – is one of the most rapidly growing segments of the global finance industry. Starting with Dubai Islamic Bank in 1975 (and operations in the United Arab Emirates, Egypt, Sudan, Lebanon, Bahrain and Pakistan etc.), Islamic finance has grown by 15 -20 percent in each of the past three years, and since the inception of modern Islamic banking the number of Islamic financial institutions worldwide has risen from one institution (i.e. in Dubai), to more than 300 institutions with operations in 75 countries and with assets more than 500 billion US$ today. Islamic banking assets and assets under management now exceed US$1.7 trillion, and the Islamic finance sector is expected to reach US$2.7 trillion by 2010.

Though initially concentrated in the Middle East (especially Bahrain) and South-East Asia (particularly Malaysia), Islamic financial system is now increasingly found elsewhere. This includes developing economies where the financial sector is almost entirely Islamic (Iran and Sudan) or where Islamic and conventional financial systems coexist (Indonesia, Malaysia, Pakistan and the United Arab Emirates). It also includes developed economies where a few Islamic financial institutions have been established and where large conventional banks have opened Islamic financing windows (such as in Europe and the United States).

While the finance on Shari'ah principles has been practiced for many centuries, the concept of contemporary Islamic finance is a recent phenomenon that developed in the last three decade. In our days, the Islamic financial institutions offering Shari'ah based or Shari'ah compliant products and services have become more widespread and substantial. The emergence and rise of these institutions is an important academic and practical development of our time.
Theoretically, the main principles upon which Islamic finance is based are:

i. the prohibition of Riba (usually interpreted as usury or interest) and the removal of debt-based financing;

ii. the prohibition of gharar, encompassing the full disclosure of information, removal of asymmetric information in contracts and the avoidance of risk-taking;

iii. the exclusion of financing and dealing in activities and commodities regarded as sinful or socially irresponsible (such as gambling, alcohol and pork);

iv. an emphasis on risk-sharing, the provider of financial funds and the entrepreneur share business risk in return for a pre-determined share of profits and losses;

v. the desirability of materiality, a financial transaction needs to have 'material finality', that is a direct or indirect link to a real economic transaction; and (vi) consideration of justice, a financial transaction should not lead to the exploitation of any party to the transaction.

In practical terms, these prohibitions and recommendations manifest themselves as the following commercial products and services offered by Islamic financial institutions:

1. **Mudarabah**, the provision of capital to a partial-equity partnership in return for a share of profits, but where the losses on funds lent are borne by the lender;

2. **Musharakah**, full equity partnerships where the provider of funds and the entrepreneur directly and wholly share in the business,
3. **Murabahah**, an instrument used for financing the purchase of goods and services where the financial institution purchases these on behalf of the customer;

4. **Bai muajjal**, deferred payments on products encompassed under Murabaha;

5. **Bai Salam**, advance or pre-paid sale contracts of goods and services;

6. **Istisna**, or manufacturing contracts to cover work in progress and paid by the financial institution on behalf of the customer;

7. **Ijarah**, lease financing in the form of operating leases only; (viii) **Takaful** or Islamic insurance in the form of cooperative self-help schemes, and

8. **Qard Hassan**, benevolent loans offered interest free. Thus, by using them, the Islamic banks, can also provide the products similar to the products and services offered by conventional banks with the exception that Islamic financing principles apply to the underlying bank assets and liabilities.

In brief, the Islamic law prohibits charging and paying of interest but allows earning profits by involving in trade and business activities. Therefore, the very prohibition of riba or interest is the core of Islamic finance which has led to the emergence of Islamic financial system. The theory of Islamic finance evolved on the basis of profit and loss sharing (PLS) principle underlying participatory Islamic financial contracts such as *Mudarabah* and *Musharakah*. However, the practice of Islamic finance does not conform to the theory and overwhelmingly relies on the *Murabahah* (mark-up) principle which motivates deferred trade. The PLS is in striking contrast to the interest mechanism, but the mark-up is not. It poses the interesting question as why the Islamic banks which, unlike conventional banks were expected to engage in equity financing, sharing profit and losses with
their clients, concentrated much on other than PLS principles. The answer can be sought in consideration with the real world situations i.e. the Islamic banks, because of obvious serious moral hazard problems, high risk and other practical problems, avoided to much engage in PLS principles and further to compete with conventional banks in the market, they needed less risky and fixed return financing techniques. Moreover, being the part of an infant industry, they had to prepare themselves to capture the market share so as to strengthen their base and get the good standing in the market. For these reasons, they turned to less risky operations rather than more risky ones, to generate the necessary profits for their depositors who wanted their funds to be invested in less risky assets than those targeted by venture capitalists.

*Murabahah* financing constitutes less risky, rather a safe operation on the part of financier, hence represented the most favoured form of finance used by Islamic banks as it accounts for about 70 percent of financial transaction.

It goes without saying that the theorists and experts in Islamic finance generally advise the use of profit/loss sharing (PLS) modes and do not encourage extensive use of *Murabahah* or other trading modes. But, as its legitimacy from *shari‘ah* position is accepted and almost all Islamic banks operating in the world are using this technique excessively as an alternative to the conventional mode of credit, studying *Murabahah* from the point of view of Islamic banking is crucial and hence is the subject of the present study.

The very purpose of this study is to provide a synoptic survey of Murabahah. The main objectives are:

(1) To give a brief historical background on the origin and growth of Islamic banking and finance with special reference to the Islamic financial intuitions of Gulf region on the basis of empirical evidences.
(2) To survey the changing trend of Murabahah financing technique over the period of time and consequent causes.

(3) To examine critically Murabahah mode of financing from legal (juristic), theoretical and practical point of view

Originally Murabahah is a sale with the declared cost plus added profit. In present days it is typically used to facilitate short-term trade transactions and has been adopted as a financing mechanism. Thus, the Murabahah, presently being used in contemporary Islamic banking is something different from classical Murabahah sale contract used in normal trade. This modern Murabahah is concluded with a prior promise to buy or a request made by a person interested in acquiring goods on credit. Under this technique, a customer wishing to buy goods requests the financial institution to purchase the items on his behalf and sell them to him at cost plus a declared profit on a deferred payment basis usually. It is thus a financing cum sale transaction. Buying the goods from the manufacturer and selling them to the borrower produces a period during which the bank owns the goods and so bears the risk. The bank, instead of sharing uncertain profit with the client, is to receive a fixed payment by a certain time. Thus, Murabahah, in economic consequence, outwardly resembles conventional consumer loan and therefore remained vulnerable to criticism since its very inception and regarded as less truly Islamic mode of finance.

However, the reason for emergence of this specific form of financing was to search for a Shari‘ah compliant financial instrument capable of competing with conventional consumer-finance products and apply it in the area where Mudarabah or Musharakah etc. failed to operate. Murabahah successfully meted the needs and proved to be a viable alternative to conventional consumer loan.

Taking cognizance of real world problem, the practice of Murabahah changed over time owing to various reasons. Over the years, a number of additional alterations have been added. Some adaptations have made it more close
to conventional loan. The introduction of *tawarruq* (commodity Murabahah) recently has aroused more controversy surrounding the *shari‘ah acceptability* of such financing method.

To conclude, Murabahah, on the one hand, is the most preferred financing technique among Islamic banks due to its nature of being less risky but on the other, it is the most criticized mode of finance as well owing to its close proximity to interest based banking method.

*Murabahah* is by its very nature focused on short-term financing. It is not capable of meeting the long-term needs of time taking industrial projects, for example. In practice *Murabahah* has been used mostly in financing trade. As a result of diverting most of its funds towards *Murabahah* Islamic banks may be failing in their expected role of mobilizing resources for development. Therefore, theorists assert that Islamic banks’ heavy reliance on *Murabahah* may not be healthy in future.

Considering the economic consequences of using the *Murabahah* operation as well as its deficiency on *shari‘ah* ground, the question arises as to what extent, the Islamic financial institutions have tried to reduce this financing method over a period of time and increase the share of sharing or equity based modes of finance after experiencing the successful operation. The answer strongly calls for an empirical study.

Hence, this study on the present subject is, to an extent, theoretical and a bit empirical in nature. It makes an attempt to study the concept of *Murabahah* theoretically and investigate its use by Islamic banks as financing method in comparison with other techniques. The efforts have been made to know as whether some changes has taken place or not with regard to the use of this form of financing *vis-à-vis* other modes over the course of the years. However, this study is limited to the commercial banks of the Gulf Cooperation Council (GCC) region for the period of 2000-2005 only. The study is exclusively based on secondary
data published by the General Council of Islamic Banks and Financial Institutions (CIBAFI), Bahrain. Trend analysis has been used as the main technique in the study and with the help of time series data, the growth and pattern of financing and investment activities of Islamic banks vis-à-vis various financing techniques have been analyzed. The relative share of each technique and method in the total investment and financing activities of Islamic financial institutions has been marked down.

The whole study has been divided into eight chapters. The first chapter introduces the main theme of the study, explaining about statement of the problem, the objectives and purpose, methodology and approach and limitation of the study.

Second chapter starts with the literature review of the Islamic finance core concept, its practices and evolution in general and Murabahah in particular so as to review Islamic financial system both in its theoretical and practical perspective. It also reviews Islamic and conventional banking, and provides a comparative analysis of the two systems detailing about the fundamentals of Islamic finance, its distinguished features and advantages and various basic issues related to sale as Murabahah is originally a sale contract and thus requires meeting the necessary rules of sale. While highlighting the main features and pre-requisites of Islamic financial system we have tried to demonstrate as in what ways it differs from the contemporary interest based banking system and how it is a viable proposition that can result in efficient resource allocation and prove to be an alternative to modern interest based financial system and further what advantages, benefits and desirable effects it produces, if such system is implemented in true sense.

The third chapter presents the background and overview of Islamic banking and finance as how its emergence and evolution took place and what was the background and main factor that led to its emergence and it being developed as viable alternative to interest based banking system. In this connection we have highlighted the recent trends and development of Islamic banking industry.
Chapter four is a broad introduction to original Murabahah contract as discussed by classical jurists. It elaborates the legitimacy and rationale, nature and classification of Murabahah contract under the legal opinions of four major school of Islamic jurisprudence viz Hanafi, Maliki, Shafi'i, and Hanbali and later on highlights the concept of contemporary Murabahah. As regards the concept of Murabahah, we have tried to analyze this specific form of contract investigating its traditional use as found in the discourse of classical Islamic jurists and its contemporary adapted structure which is particularly being used for financing. It also deals with different financing techniques used by Islamic banks so as to demonstrate the nature and function of these methods in contemporary Islamic banking.

Chapter five focuses on Murabahah as a mode of finance, its theoretical development, practical aspects and procedures. It discusses the basic features and conditions of Murabahah guiding its adoption, some important aspects and its applicability to meet the various needs of finance practiced by contemporary Islamic banking industry.

Chapter six focuses on empirical analysis of Murabahah operation, it shows the recent trends & growth rate of Murabahah financing during the period 2000-05 and analyses it on the basis of empirical evidences and explores the causes of rise in Murabahah financing and its decline. It also studies Murabahah financing with other modes of finance comparatively.

Chapter seven analyses the contemporary issues, practical aspects and problems arises in Murabahah financing such as increased price in credit sale, rebate in the case of early payment, use of interest rate as benchmark for mark-up determination, bindingness of promise on the part of clients, problem of defaulting and issue of imposing penalty in the case of unscrupulous defaulters etc.
Chapter eight of the thesis provides a summary and conclusion of the study and some suggestions. The thesis ends with the relevant glossary of Arabic terms and bibliography.

The main findings of the study can be summarized as follows.

1. *Murabahah* is still a dominant and widely used financing technique in comparison with other Islamic methods of finance.

2. The present practice in respect of credit involved financing as such in Murabahah is completely at variance with that obtained in classical *Murabahah*.

3. *Murabahah* has played the major role in the growth of Islamic banking and finance industry.

4. The attitude of Islamic banks while practicing *Murabahah* is largely focused on to mitigate the risk as much as possible and make it a close competitive alternative to conventional loans as it is evident from the introduction of commodity Murabahah/ dealing in synthetic *Murabahah* in which the essentials of *Murabahah* esp. the actual ownership of goods is rather symbolic than real.

5. *Murabahah* is the most dominating financing technique used by Islamic banks in GCC countries, staying its average percentage share at (56.13%) over the period 2000-05 followed by *Muajjal* and *Ijarah* which averaged out at (27.27%) and (6.41%) over the period 2000-05 respectively.
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This is to certify that Mr. Khalid Waheed, En. No. BB-3187 has completed his thesis entitled "A Critical Study of Murabahah as an Islamic Mode of Financing". It is an original research work and has been written under my supervision. This study in my opinion is suitable for submission for the award of the Degree of Doctor of Philosophy in Economics of Aligarh Muslim University, Aligarh, India.

Dr. S. M. Jawed Akhtar
(Supervisor)
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ACKNOWLEDGEMENT

My foremost gratitude goes to my research supervisor, Dr. S. M. Jawed Akhtar, whose meticulous supervision, continuous encouragement and intelligent guidance made it possible for me to present my work in the present form. Without his special direction, this work would not have been possible as I had absolutely felt myself to be incapable to complete such work that particularly concern with a new complex field of knowledge.

I owe special thanks to Prof. Abdul Wahab, Chairman, Department of Economics, AMU, Aligarh for providing me wholehearted academic support to complete my research work and all my teachers for their sincere cooperation particularly Prof. M. Masood, Dr. Izhar Ahmad, Dr. Noman Ahmad and Dr. Abdus Salam.

I am highly indebted to Prof. Abdul Azim Islahi, King Abdul Aziz University, Jeddah who motivated me to register for a research degree and encouraged me in pursuing it. His ever so helpful attitude, continuous support in acquisition of the relevant materials with useful comment and advices helped me a lot that defies description.

Among many people who have contributed to the progress of this research in different ways, the following deserve special mentioning: Prof. M. Nejatullah Siddiqi who particularly helped me in focusing on the issues pursued in this research through writing comments and offering valuable observation and suggestions to improve my work, Dr. Shariq Nisar who provided me all possible help to his best, Prof. Fazlur Rahman Faridi with whom I had the benefit of discussion to gain insight on the issue, Dr. Naser Al-Ziyadat, Research Director at the General Council of Islamic Banks and Financial Institutions (GCIBAFI), Bahrain who provided me the needed data to analyze my study empirically, Dr. Obaidullah, KSA, Syed Farouk,
Bahrain, Dr. Muhammad Azhar and Dr. Raziul Islam Nadvi, Aligarh from whose comments and observations I benefited.

I owe my sincere gratitude to all my seniors and wonderful friends especially Mr. Jameel Ahmad, Dr. M. Qaisar, Dr. Abu Shariq for their cooperation.

I have also had the fullest cooperation from the staff of Maulana Azad Library, AMU, Aligarh especially Mr. Masood Ahmad, Assistant Librarian and the staff members of its Online Journal Section particularly Mr. Arshad Iqbal and Mr. Farrukh Laieque, Seminar Library, Department of Economics, Indian Association for Islamic Economics (IAFIE), Aligarh, Institute of Objective Studies (IOS), New Delhi, Research Intelligence Unit, Sri Lanka for providing me facility to collect data and other relevant information.

Thanks are also due to all the members of Islamic Banking and Finance Community (IBFnet) in the Yahoogroups mailing list. From their useful scholarly discussion, I benefited a lot.

Last but not the least I take this opportunity to pay love and respect for all my family members specially Mr. Saquib Mohtashim, LLM, an elder brother of mine whose support acted not only as facilitator but also was a source of continuous inspiration. Finally, I dedicate this work to my beloved parents, Mr. Abdul Wadood and Mrs. Soghra Bano.

Views, interpretations, and omissions and errors are my sole responsibility.

(Khalid Waheed)
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<tr>
<td>AAOIFI</td>
<td>Accounting and Auditing Organization for Islamic Financial Institution</td>
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<tr>
<td>AH</td>
<td>After Hijrah</td>
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<tr>
<td>BC</td>
<td>Before Christ</td>
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<tr>
<td>CII</td>
<td>Council of Islamic Ideology</td>
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<td>FIFO</td>
<td>Federation of Interest Free Organization</td>
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<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<td>GCBAFI</td>
<td>General Council for Islamic Banks and Financial Institution</td>
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<td>IBs</td>
<td>Islamic Banks</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IFIs</td>
<td>Islamic Financial Institutions</td>
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<td>IFSI</td>
<td>Islamic Financial Service Industry</td>
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<td>IFSB</td>
<td>Islamic Financial Service Board</td>
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<tr>
<td>IIFM</td>
<td>International Islamic Financial Market</td>
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<td>IIRA</td>
<td>International Islamic Rating Agency</td>
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<td>IDB</td>
<td>Islamic Development Bank</td>
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<td>IRTI</td>
<td>Islamic Research and Training Institute</td>
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<tr>
<td>LIBOR</td>
<td>London Inter Bank Offer Rate</td>
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<tr>
<td>L/C</td>
<td>Letter Of Credit</td>
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<tr>
<td>NBFCs</td>
<td>Non Banking Financial Companies</td>
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<td>NBFIIs</td>
<td>Non Banking Financial Institutions</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>OIC</td>
<td>Organization of Islamic Conference</td>
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<tr>
<td>PLS</td>
<td>Profit and Loss Sharing</td>
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<td>PBUH</td>
<td>Peace Be Upon Him</td>
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<tr>
<td>UAE</td>
<td>United Arab Emirates</td>
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<td>IFSL</td>
<td>Islamic Financial Services London</td>
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<td>MENA</td>
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CHAPTER - I

INTRODUCTION
INTRODUCTION

1.1 Background & Theoretical Framework:

As originally held by the theorists, the risk-sharing is the core principle of Islamic finance, upon which they produced the Islamic banking model in the form of 
mudarabah and musharakah. Thus, unlike conventional banks, Islamic banks were expected to engage in equity financing, sharing profit and losses with their clients. But it could no longer gain momentum and good footing into the market in the real world and proved to be too risky and difficult (due to obvious moral hazard problems and other reasons) to make it practical and viable in the prevailing environment where the Islamic banks were also to compete with conventional banks. Further, being the part of an infant industry, they had to prepare themselves to capture the market share so as to strengthen their base and get the good standing in the market. They turned to less risky operations rather than more risky ones, to generate the necessary profits for their depositors who wanted their funds to be invested in less risky assets than those targeted by venture capitalists.

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Experts in Islamic finance generally advise the use of profit/loss sharing (PLS) modes and do not encourage extensive use of *Murabahah* or other trading modes. But, as its legitimacy from *shari'ah* position is accepted and almost all Islamic banks operating in the world are using this technique excessively as an alternative to the conventional mode of credit, studying *Murabahah* from the point of view of Islamic banking is crucial and hence is the subject of the present study.
Several reasons are given for the popularity of Murabahah in Islamic banking investment operations:

1. Murabahah is a short-term investment mechanism and, compared with Profit and Loss Sharing (PLS), is convenient.

2. Mark-up in Murabahah can be stipulated in a manner which ensures that the Islamic banks are able to earn a return comparable to that of conventional banks with which they are in competition.

3. Murabahah avoids the uncertainty attached to earnings of businesses under a system of PLS, and

4. It does not allow the Islamic banks to interfere with the management of the business since the bank is not a partner with the client but their relationship, instead, under Murabahah, is that of a creditor and a debtor respectively.

Originally Murabahah is a sale with the declared cost plus added profit. In present days it is typically used to facilitate short-term trade transactions and has been adopted as a financing mechanism. Thus, the Murabahah, presently being used in contemporary Islamic banking is something different from classical Murabahah sale contract used in normal trade. This modern Murabahah is concluded with a prior promise to buy or a request made by a person interested in acquiring goods on credit. As such, it is called "Murabahah to Purchase Orderer". The AAOIFI's Shari'ah Standard on Murabahah is also based on this arrangement. Under this technique, a customer wishing to buy goods requests the financial institution to purchase the items on his behalf and sell them to him at cost plus a declared profit on a deferred payment basis usually. It is thus a financing cum sale transaction. Buying the goods from the manufacturer and selling them to the borrower produces a period during which the bank owns the goods and so

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Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)
bears the risk. The bank, instead of sharing uncertain profit with the client, is to receive a fixed payment by a certain time. Thus, Murabahah, in economic consequence, outwardly resembles conventional consumer loan and therefore remained vulnerable to criticism since its very inception and regarded as less truly Islamic mode of finance.

Murabahah financing leaves the entire results of the use of the commodity financed in productive enterprise for the user. It is the one to bear losses, if any, and it is the one who owns all the profits. The financier has no share in the profit of Murabahah-financed enterprise. That sounds good for the incentive to work and manage the enterprise to the best of one's capacity. No agency problem and no moral hazard.

As it is believed that the original type of Murabahah arose as a result of a buyer wanting to buy certain goods but he did not have expertise and much knowledge about price, quality of the goods or markets etc. Hence he engaged the services of another person who was conversant with these aspects and offered him remuneration for his expertise as a mark-up on the goods. Here the aspect of credit does not enter into the relationship between the two at all. Hence present practice in respect of credit involved financing as such in contemporary Murabahah is completely at variance with that obtained in classical Murabahah.

The reason for emergence of this specific form of financing was to search for a Shari'ah compliant financial instrument capable of competing with conventional consumer-finance products and apply it in the area where Mudarabah or Musharakah etc. failed to operate.

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4 Siddiqi, M.Nejatullah (2004), 'Riba, Bank Interest and the Rationale of its Prohibition', Jeddah, KSA, IDB/IRTI, p. 73
Taking cognizance of real world problem, the practice of Murabahah changed over time owing to various reasons. Over the years, a number of additional alterations have been added. Some adaptations have made it more close to conventional loan. One of the main legal (fiqhi) point concerning the actual ownership of the goods by financial institutions seems in certain types of Murabahah deal (such as synthetic Murabahah) to be more symbolic than real. The duration theoretically is of merely a moment. The banks, therefore, is doubted to truly assume possession, even constructively. Further, the risks taken by the banks are most of them if not all of them, insurable. It is easy thus to pass on the cost involved to the customer as part of the mark-up. The introduction of tawarruq (commodity Murabahah) recently has aroused more controversy surrounding the shari‘ah acceptability of such financing method. Critics sternly disapprove this form and hold the view that it has significantly compromised its identity as Shari‘ah compliant method. As a result of criticism, many financial institutions have vowed to start phasing out certain types of Murabahah operation, though in practice this remains to be seen.

Despite many improvements over the way Murabahah was practiced, there are a number of factors attracting the criticism and thereby it needs some fine-tuning to bring it nearer to the ethos of Islamic finance.

To sum up, on the one hand, Murabahah is the most preferred financing technique among Islamic banks due to its nature of being less risky but on the other, it is the most criticized mode of finance as well owing to its close proximity to interest based banking method.

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5 Warde, Ibrahim (2005), Corporate Governance and the Islamic Moral Hazard, op. cit. p. 19
6 Siddiqi, M.Nejetullah (2004), ‘Riba, Bank Interest and the Rationale of its Prohibition’ op. cit. p. 75
7 Vogel and Hayes (1998): 143, as cited by Ibrahim Warde, op. cit. p. 19
1.2 Statement of the Problem:

The trade-off between the need to preserve distinctive identity of *Murabahah* and the needs of the market place led the practitioners to be in dilemma. Recent adaptation made this technique more vulnerable to criticism on *shari'ah* ground. It is interesting to know what the real causes that resulted into mess are and what should be the measures to sort it out.

In *Murabahah*, debt obligation in the form of installments incurred by customers may be criticized for promoting debt transactions in the society and thereby giving rise to the ills of a debt driven financial system and jeopardizing the pro-stability of the Islamic financial system.

One then wonders whether the Islamic finance model based on predominantly debt-based solution will end up experiencing the same problems encountered in the conventional finance model.⁸

*Murabahah* is by its very nature focused on short-term financing. It is not capable of meeting the long-term needs of time taking industrial projects, for example. In practice *Murabahah* has been used mostly in financing trade. As a result of diverting most of its funds towards *Murabahah* Islamic banks may be failing in their expected role of mobilizing resources for development.⁹

In view of the above fact, it can be concluded that the Islamic banks’ too much reliance on *Murabahah* may not be healthy in future. Now the question arises:

Considering the economic consequences of using the *Murabahah* operation as well as its deficiency on *shari’ah* ground, to what extent, the Islamic financial institutions have tried to reduce or phase out this financing method over a period

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⁹ Siddiqi, M. Nejatullah (2004), ‘*Riba, Bank Interest and the Rationale of its prohibition*’, op. cit., p. 75
of time and increase the share of sharing or equity based modes of finance after experiencing the successful operation. The answer strongly calls for an empirical study.

While much discussion has taken place and some good literature has been produced, they are exhibited on theoretical plane concerning the various issues of contemporary Murabahah and controversy surrounding its latest practices. The practical and operational aspects with empirical study have not received as much attention. Thus, it can only be surmised that since its inception, Murabahah financing techniques remained as a leading method for providing finance by Islamic banks but how much Islamic banks used Murabahah as well as other modes of finance over the years and what are their relative share in IFIs’ financing activities, what is the incidence of use of various financing methods esp. Murabahah, which of these methods are more amenable for use in certain sectors, how much they are allocated to various sectors of the economy like manufacturing, trade, agriculture and what are their term structure etc., what are the economic repercussions in using sharing and non-sharing based modes. For example, in the absence of empirical evidence, it can only be surmised that the larger the ratio of demand deposits on the liabilities side and the more the ratio of debt finance (based on debt-generating modes like Murabahah and leasing) the more the vulnerability of the system to liquidity problems and threats of bankruptcy.10

It is also needed to set out to determine the significance of each of the Islamic financing techniques in the total operations of Islamic banks and whether

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there have been any changes over a period of time in the composition of the financing techniques used by various Islamic banks.\(^{11}\)

These are basically empirical questions and can not be answered without reference to actual practices of Islamic banks. Though, of late, some studies on this line, has been made to attempt to focus on such issues but they are not significant. The detailed studies on various aspect of murabahah financing from this perspective are not good enough and it is difficult to even surmise its latest trend. Hence, this study on the present subject is, to an extent, theoretical as well as somewhat empirical in nature. It makes a little attempt to study the concept of Murabahah theoretically and investigate of its use and practice by Islamic banks as financing method in comparison with other techniques. The efforts have been made to know as whether some changes has taken place or not with regard to use of this form of financing vis-à-vis other modes over the course of the years and as to what extent other instruments has been given place including the introduction of new methods to meet the need of finance in contemporary world. However, the researcher who is interested in such issues found himself confronted by a major difficulty i.e. the non-availability of relevant data. The annual reports of Islamic banks which mostly contain statements of balance sheets and profits & loss accounts cannot provide any information on these issues.\(^{12}\)

Experts in Islamic Economics and finance generally advise the use of profit/loss sharing (PLS) modes and do not encourage extensive use of Murabahah or other trading modes. But, as its permissibility is beyond doubt and all Islamic banks operating in the world are using this technique excessively as an alternative to the conventional mode of credit, studying Murabahah from the point of view of Islamic banking is crucial and hence is the subject of the present study.

\(^{11}\) Ahmad Ausaf (1987), Relative Significance of various Financing Technique of Islamic Banking: Evidence from Islamic Banks, Paper presented at The Sixth Annual Conference of The Royal Academy For Islamic Civilization Research (Al al-Bait Foundation, Amman, Jordan

\(^{12}\) Ahmad Ausaf (1987) op. cit.
1.3 Objective of the Study:

The primary objective of this study is to analyse theoretical and practical aspects of the most favoured form of Islamic financing i.e. Murabahah (Mark-up). A comparative analysis between variable return and fixed return modes is made and the difference between Islamic and conventional banking is critically examined in this study. In other words, the main purpose of this study is to investigate the Murabahah financing technique and to analyze its increasing share in total financing operations of Islamic banks over time in comparison with other techniques.

In dealing with these issues, the study aims to achieve the following objectives:

(1) To give a brief historical background on the origin and growth of Islamic banking and finance with special reference to the Islamic financial intuitions of Gulf region on the basis of empirical evidences.

(2) To identify and evaluate the major modes of Islamic financing instruments in general and Murabahah in particular in the light of Islamic economics principles and suggest means to achieve the higher level of compliance.

(3) To survey the changing trend of Murabahah financing technique over the period of time and consequent causes.

(4) To ascertain the problems associated with the Murabahah transactions and to highlight its relevance as a mode of finance to the socio-economic problems of Muslims.

(5) To examine critically Murabahah mode of financing from legal (juristic), theoretical and practical point of view.

(6) To offer some tentative suggestions on the subject based on the findings of the research.
1.4 **Methodology and Approach of the Study:**

The methodology adopted for this study involves the following:

1. The collection of material on Islamic banking and finance with focus on *Murabahah*, from various sources both within and outside India and survey of the available literature related to the subject.

2. Examination of the secondary data on the subject through a study of dissertations, annual reports, balance sheets, brochures, journals, periodicals, bulletins, handouts, newspapers etc.

In an empirical study, it is possible to adopt either a country-based or an institution-based approach. However, on account of the limited nature of the available information, neither of these approaches has been fully adopted. Instead, an attempt has been made to use country-based approach to the possible extent.

1.5 **Assumption of the Study:**

Despite some deficiencies on *Shari’ah* ground *Murabahah* meets the preference of investors and depositors for risk free returns comparable to the market rate of interest. This is the reason for predominance of *Murabahah* in the Islamic financial market. However, as the Islamic Financial Institutions’ market share grows, investors desire higher returns and depositors listen to the critique of *Murabahah*, there is likely to be a decline in its market share, losing to profit sharing based modes of finance such as *Mudarabah* and *Musharakah*.

1.6 **Scheme of the Study:**

The thesis is divided into eight chapters. The *first chapter* is an introduction to the study. It explains statement of the problem, the objectives and purpose, methodology and approach and limitation of the study.

*Second chapter* starts with the literature review of the Islamic finance core concept, its practices and evolution in general and Murabahah in particular so as to
review Islamic financial system both in its theoretical and practical perspective. It also highlights the fundamentals of Islamic finance, its distinguished features and advantages. In particular, it reviews Islamic and conventional banking, and provides a comparative analysis of the two systems. It also discusses some basic issues regarding Islamic concept of sale & contract and business ethics.

The third chapter presents the background and overview of Islamic banking and finance as how its emergence and evolution took place and what was the background and main factor that led to its emergence and it being developed as viable alternative to interest based banking system. In this connection we have highlighted the recent trends and development of Islamic banking industry.

The fourth chapter is a broad introduction to original Murabahah contract as discussed by classical jurists. It elaborates the legitimacy and rationale, nature and classification of Murabahah contract under the legal opinions of four major school of Islamic jurisprudence viz Hanafi, Maliki, Shafi‘i, and Hanbali. It also deals with different financing techniques used by Islamic banks so as to demonstrate the nature and function of these methods in contemporary Islamic banking.

Chapter five focuses on Murabahah as a mode of finance, its theoretical development, practical aspects and procedures. It deals with the basic features and conditions of contemporary Murabahah guiding its adoption, some important aspects and its applicability to meet the various needs of finance practiced by modern Islamic banking industry.

Chapter six focuses on empirical analysis of Murabahah operation, it shows the recent trends & growth rate of Murabahah financing during the period 2000-05 and analyses it on the basis of empirical evidences and explores the causes of rise in Murabahah financing and its decline. It also studies Murabahah financing with other modes of finance comparatively.
Chapter seven analyses the contemporary issues, practical aspects and problems arises in Murabahah financing such as increased price in credit sale, rebate in the case of early payment, use of interest rate as benchmark for mark-up determination, bindingness of promise on the part of clients, problem of defaulting and issue of imposing penalty in the case of unscrupulous defaulters etc.

Chapter eight of the thesis provides a summary and conclusion of the study and some suggestions.

1.7 Limitation of the Study:

Because of inadequacy, non-access and the lack of the relevant data, we have included the data of the Gulf Cooperation Council (GCC) countries' commercial banks only. Thus, quality of data leaves something to be desired. However, one must not neglect the fact that the relevant data of the banks of GCC countries can not be underestimated as they constitute considerable share in Islamic banking industry. Further, our time series is not long enough as the study covers the period of 2000-05 only.
CHAPTER - II

LITERATURE REVIEW

& SOME BASIC ISSUES
2.1 General Review: Islamic Banking Concept

2.1.1 Riba and Reasons for its Prohibition

Elimination of interest or *riba* is the core concept of Islamic financial system. It goes without saying that the *Qur'an* has unambiguously and in the most stringent term prohibited *riba*. *Sunnah* further clarifies the concept and the scope of *riba* and its prohibition by its application to barter to barter and exchange of money for money. Despite some controversy in application, the core idea was held unanimously throughout Islamic history. But during the early and mid twentieth century, there started appearing divergent opinions concerning definition of *riba* particularly with discussion on bank interest. The first opinion held by the majority of the scholars was that all forms of fixed return on lending or any excess over it, irrespective of its amount or percentage, would be considered to be *riba* and therefore prohibited. They argued, since interest, whether exorbitant or reasonable, was an addition to the capital borrowed, it was thus, a *riba* and therefore did not comply with the crystal clear teachings of *Qur'an* and *Sunnah* in this regard. Thus they defined *riba* or interest, as any predetermined fixed return for the use of money. It was believed irrelevant whether the *riba* relates to loan for consumption or productive purposes, whether the loans are personal or commercial, whether the borrower is government, a private individuals or a company and whether the rate of interest is high or low.

Another opinion emerged on the issue in question was that it was only usury (the exorbitant rate), which happened to be exploitative, thus prohibited. They argued that since bank interest being a profit, earned on its operation, could not be regarded as *riba*. The bank interest is different as it does not go against the very norms of

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justice, so there is no moral case against it. They considered interest to be prohibited only when it would seem to be exorbitantly high and exploitative. Therefore, the normal interest cannot be regarded as riba as it is paid by rich banks to ordinary people in contrast to the case prevalent in old Arabia i.e. excess amount paid to rich moneylender by poor people. Further, they were of the opinion that interest as a cost payment should be permitted when they are used;

- By the government to induce savings to finance trade.
- As a fine or punishment for debtors who have not fulfilled their obligations willfully and
- For loans made to finance productive investment.  

It was also argued that in an inflationary economy lender would be exploited due to fall in the future value of his money and since Shari‘ah had not permitted exploitation therefore at least to charge extra to compensate (i.e. compensatory) could not be regarded as prohibited. Another argument on the same line was that, since Islam, being the religion of all people and all times to come, could not deprive its people of enjoying banking facilities or make its masses isolating from the benefit of such a large indispensable sector, this argument was based on the perceived notion that banking without interest is not possible at all.  

There was a third but small group who firmly held that Muslims should have no deal with contemporary interest based banking system as it is principally based on riba. As a result of disregarding this system, the necessities arise can be met through some other alternatives. Bait-al Mal (public treasury) like institutions can also offer some of the basic services which are provided by these banks like saving deposit, current deposit and vault facilitation etc. They argued that the bank interest is against

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the very basic objectives of the Shari'ah. Hence it is imperative for Muslims to completely disregard such anti-Islamic system

Anyway, three main reasons for Islamic prohibition of riba as mentioned by Cummings et al are as following;

- Interest or usury reinforces the tendency of wealth accumulation in the hands of few.
- Islam does not allow gain from financial activity unless the beneficiary is also subject to risk.
- Islam regards the accumulation of wealth through interest as selfish.  

Siddiqi singles out five reasons inferring from the Qur’anic texts. The main economic reasons given for the prohibition of riba were that it would hamper investment and employment and be always exploitative and bring instability to the economy. Some other reasons put forward by Islamic economists can be summarized as follows.

1) Transaction based on interest violates the equity aspect of economic organization. The borrower is obliged to pay a pre-determined interest on the sum even though he may have incurred a loss. A fixed charge on capital is unjust since the results of productive enterprise in which capital is invested are uncertain.

2) The inflexibility of an interest based system in loss situation leads to a number of bankruptcies resulting in loss of productive potential and unemployment.

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7 They are: (1) Riba corrupt society (2) It implies improper appropriation of other people’s property. (3) Its ultimate effect is negative growth (4) It demeans and diminishes human personality. (5) It is unjust.
A system based on profit sharing is more stable than a system based on fixed charge for capital since the cost of capital in a sharing system automatically adjust itself to variations in productivity under changing business conditions. A shock to asset position is automatically absorbed on the liability side.

3) The interest system dampens investment activities because it adds to the cost of investment. Allocation based on profit sharing pays more attention to investment profitability, while allocation based on interest pays more attention to credit worthiness.

4) The interest-based system is security-oriented rather than growth oriented.

5) The interest-based system discourages innovation, particularly on the part of small-scale enterprises.

6) Under the interest based system banks are only interested in recovering their capital along with interest.

7) Under profit sharing system it is the real sector of the economy which determines the rate of return unlike in the financial sector which is based on interest. This system (PLS) puts a check on the supply of money and controls inflation.

8) Risk sharing system will bring more innovation in the economy and encouraged new entrepreneurs to venture into the market.

Abdul Mannan in his book *Islamic Economics: Theory and Practice*, sums up the Islamic point of view on interest in these words “Islam prohibits interest because interest has nothing to do in influencing the volume of savings, because it makes depression chronic, because it aggravates unemployment problem and, finally because it encourages unequal distribution of wealth”.

The issue of *riba* and interest, however, kept haunting time and again in various Muslim countries. However, the matter was finally set-aside during the

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Islamic Conference held in Jeddah in 1973. On the basis of this the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC), in the year 1985, adopted a universal and comprehensive definition of *riba* in these words, "any increase or profit on a loan which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay, and any increase or profit on the loan at the inception of the loan agreement, are both form of usury (*riba*), which is prohibited under the *Shariah*."

There is now general consensus among Muslim religious scholars and economists that there is no difference between usury and interest. At least four characteristics define its prohibition.

1. It is fixed *ex ante*.
2. It is tied to the time period and the amount of the principal.
3. Its’ payment is guaranteed by the borrower regardless of the outcome of the transaction for which the money was borrowed.
4. The state apparatus sanctions and enforces its collection.

To conclude, during the modern times which dominate interest based banking system, having driven by the viability of the contemporary banking system, controversy has aroused about the bank interest as to whether it is the same *riba* prohibited in *Qur’an* or not. The overwhelming majority regard it as *riba*, whereas few ones see it is not. They feel the need for having a fresh look at the law of *riba* with a view to finding a way out regarding the legitimacy of bank interest. In the words of Siddiqi, “The principle that the excess charged over the principal in the case of a loan is *riba* beyond doubt and thus, the bank interest is *riba*. Those trying to

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12 For detailed exposition on the issue of *riba* and bank interest, see, Siddiqi, M.N. (2004), ‘Riba, Bank Interest and the Rationale of its Prohibition’, esp. chapter 2 entitled ‘Prohibition of Interest’ op. cit. pp. 35-63. It is one of the latest works on the subject that comprehensively deals with the issue in question.

legitimize bank interest by arguing that it is different failed to prove their case. The Muslims in general, did not accept the idea even while dealing with banks out of necessity or for the sake of convenience. A section of them kept away from banks and tried to develop alternatives to help the community survive. These efforts got a fillip from the Muslim countries coming out of foreign rule one after another between 1945 (Indonesia) and 1964 (Algeria). It was no accident that the same pried saw the ad vent of the theory of interest-free banking and some modest beginning in its practice. Simultaneously we find a a number of institutions devoted to Islamic research reaffirming that bank interest was covered by the prohibition of *riba*.”

2.1.2 The Rationale of Islamic Banking

The rationale of Islamic banking revolves around two basic questions. Firstly, is the financial intermediation necessary? And secondly, is the financial intermediation possible without interest?

As for the first question, Islamic economists are convinced that financial intermediation is necessary. In the words of professor Sidiqi, “we suggest that financial intermediation is a necessity (*darurah*) in the full technical sense of the *Shariah* term. If an Islamic society does not have financial intermediaries it will either become weak and wither away or people alien to that society will take over the function of financial intermediation with dire consequences for its financial as well as monetary system”.

Some other reasons mentioned by Islamic economists, for the necessity of financial intermediation, are the same as put forward by the conventional economists. For example financial intermediation enhances the efficiency of the saving and investment process by reducing transaction costs and eliminating the mismatches inherent in the needs of surplus and deficit units of economy. Besides this agency

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problem arising due to asymmetric information is also reduced by financial intermediation. Munawar Iqbal et al stress that “Islamic financial intermediation endeavors to replace interest by other modes and instruments both for mobilizing savings and putting those savings into productive use. The functions that the banks perform are important whether the economy concerned is secular or Islamic. People need banking services. Now, since the banking services are needed but interest is prohibited, Islamic economies have to find alternative ways of performing various banking functions. This challenge provides the rationale of Islamic banking.”

As for the second issue i.e. is financial intermediation possible without interest or fixed payment basis. Islamic economists reply in affirmative. They are of the opinion that it is not only possible but more desirable and efficient in many ways. As noted in the Pakistan Shariat Court judgment on riba, “The writers on Islamic economics are unanimous on the point that banking system can discharge all its present day functions even without the element of interest. These thinkers also agree that the reorganizing banks on Islamic lines should be done on the basis of Shirkah and Mudarabah.”

Contemporary commercial banking activities are based on creditor and debtor relationship where banks only play intermediary roles between the savers (depositors) and the investors (borrower). It charges higher interest from the borrower and pays lower to the depositor the balance (spread) is kept by the bank to meet its own costs and pay for its shareholders. This kind of creditor-debtor relationship is not permissible under Islamic law framework. The other Islamic

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16 Agency problems arise when one party serves as an agent for another. The two major types of problems are that of moral hazard and adverse selection. Moral hazard arises due to hidden action when one party has the incentive to shift the risk onto another uninformed party. Adverse selection is due to hidden information, when one party has access to more information. Agency problem also occurs due to a conflict arising out of selfishness. Weak regulatory and legal systems worsen this problem. (For its analysis, see, Nadim ul Haq, ‘Developing of Financial markets in Developing Economies’, Address at the Financial Reform Conference, Trans Asia Hotel, Colombo, Sri Lanka, March 18, 2002).


18 For more details please see the above section, ‘the idea of Islamic banking’.

19 Pakistan Federal Shariat Court Judgment on Interest (Riba), Islamic Economics Translation Series No. 8, IDB/IRTI, Jeddah, 1995, p. 74.
principle in matter of Islamic financial transaction is that there should be no reward without bearing the risk which is applicable both to labour and capital, i.e. no payment is allowed to labor unless it is applied to work, no reward for capital should be allowed unless is exposed to business risks. Financial intermediation in an Islamic framework is based on these two principles.²⁰

Shaikh Mahmud Ahmad combed through nearly all theories of interest developed since the time of Adam Smith to show that there had been no satisfactory explanation of existence of a fixed and predetermined rate of return to financial assets. He further went on, analyzing the writings of economists such as Keynes, Bohm Bowerk, Cassels, and Samuelson, to argue that an objective assessment of these writings would lead one to believe that all of these writers held a reasonably strong conviction that the existence of a fixed and predetermined rate of interest was an impediment to the process of economic growth and development. Mohsin S. Khan, in his article 'Islamic Interest-Free Banking: A Theoretical Analysis,' remarks²¹ that the abolition of interest-based transactions is not a subject alien to even western economic thought. Several western writers including Fisher, I., 100 % Money, 1945, Simons, H., Economic Policy for a Free Society, (1948) and Friedman, M., 'The Monetary Theory and Policy of Henry Simons,' in Friedman, M., (ed.), The Optimum Quantity of Money and Other Essays, (1969), among others, have argued that the current (one-sided liability) interest-based financial system is fundamentally unstable.²² In Simon's view the basic flaw in the traditional system is that, as a crisis developed and earnings fell, banks would seek to contract loans to

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²⁰ Cizaka, Murat, “Historical Background” in Encyclopedia of Islamic Banking & Insurance, Published by Institute of Islamic Banking and Insurance, London, 1995, p.17.
²² Monetary economists insist that a zero nominal interest rate is a necessary condition for optimal allocation of resources. They argue that after switching from metallic to fiat money, adding one marginal unit of real balance costs no real resources to the community. Therefore, imposing a positive price on the use of money would lead traders to economize on the use of money, in their pursuit to minimize their transaction costs. They would therefore use some real resources instead of money. However, when the rate of interest is zero traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment.
increase reserves. Each bank could do so, however, only at the expense of other banks.23

Frequent economic and banking crises especially banking failures in the United States during 1930s and in 1980s only increased the consternation and led to belief that there is something fundamentally wrong with the modern banking sector. Many experts held that fractional reserve banking system was inherently unstable and therefore should be replaced with two separate financial institutions.24 Such arguments for a system based on profit & loss concept have also been made in the wake of bank failures in other countries.

1. Deposit Banks with 100% reserves.

2. Investment Trust, to perform the lending functions.

Abbas Mirakhor, associated with the International Monetary Fund (IMF), in his article Progress and Challenges of Islamic Banking speaks about the conventional economists who during late 1950s tried to answer two fundamental questions regarding banking system that had not been addressed (1) Why did banks develop and (2) why were all their operations based on fixed fee contracts? Mirakhor says that these questions were unfortunately, albeit indirectly, relevant to the theory of Islamic banking25.

The explanation given for the existence of banks was “necessity of an intermediate between the preference of lenders for short term liquid assets and the preference of borrowers for long term illiquid liabilities. Another was that bank being operating at high volume enjoy benefits from economies of scale. According to Mirakhor, the second question why do banks operate at fixed fee basis has been much harder to explain, not only this but many other related questions regarding

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interest rate ceilings on bank liabilities and other controls and regulations like reserve requirements, control on assets and entry and deposit insurance needed answers.

By the mid 1980, economic and financial theory had shown that there was disadvantages in the fixed pay off contracts that dominated interest based banking because: (Following conclusions were drawn concerning fixed pay off contracts.)

- These contracts create inefficient default or non-performing assets.
- In the presence of asymmetric information, debt contracts suffer from adverse selection effects and moral hazard effects.
- Reserve requirements gave unnecessary extra liquidity to the regulatory authority, which in many cases aggravated the fiscal imbalance.
- Deposit insurance reduced the depositor’s willingness to watch the functions of these banks. All the above had an adverse effect on the functioning of these banks especially during crises.
- Fixed fee contracts create a fundamental conflict between the interest of the borrowers and the lenders.
- Socially desirable sectors with low profitability would not get finance. More over new entrepreneurs with good projects may not get finance in absence of security required.
- It has been observed that during the crises, to attract more deposit these institutions have increased their deposit rates while their earning reduced and thus they trapped into the crises.

Having examined the resulting effects of fixed pay off contracts, the reasons for a system free from such undesirable effects were put forth as:

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26 Ibid., p. 6.
• On the contrary, Islamic banks are those, which are based on equity finance and are more immune to such crises. The real value of their assets and liabilities would be equal to all points to time. There will be a close relationship between investment and deposit fields.

• Return on liability is the direct function of the return to assets.

• Adjustment to shock that results in banking crises and disruption of the payment mechanism is more rapid than in conventional system.

Siddiqi in his paper on ‘Rationale of Islamic Banking’ first made a critique on debt finance and the function of contemporary banking system on the basis of fixed interest payment and pointed out the resultant unhealthy repercussions on the economy and society as a whole. He dealt in detail with undesirable effects of modern banking system under the heads:

In view of adverse outcome emerged from the practices of modern banking system and thus its incapability of ensuring the best interest of the people, he proposed, as an alternative, the concept of interest free-banking system primarily based on profit sharing model.\textsuperscript{28} He put forward many advantages and benefits of profit-sharing mode like allocative efficiency, stability in the value of Money, increase in the volume of investment, justice and Equity in distribution, curbing speculation, mobilization of savings and profitability of investment etc.

2.1.3 The Theoretical Preparation for Islamic Banking

Theoretical development of Islamic banking can broadly be divided into following subheads:

2.1.3.1 Early Writings on Islamic Banking

These are several writings of the classical Islamic economists who are considered to be the founding pillars of the modern Islamic banking. Their ideas were

\textsuperscript{28} See for details, Siddiqi, MN (1983), ‘Issues in Islamic banking’ Selected Papers, Leicester: Islamic Foundation (Section: Rationale of Islamic Banking) pp. 67-96
taken up and followed by others in the later years for the developments of the Islamic banking. Owing to very fast developments, in recent years, the works of these writers may not be looked as very clear in perception but they obviously are considered to be the architects of Islamic banking mainly for conception and proposition of their ideas. An analysis of the literature on the subject reveals that during the first half of the 20th century, almost half of the total literature available in the world was in the Urdu language the rests being either in English or in Arabic language.29

Some Muslim intellectuals and Ulama like, Maulan Syed Abul Ala Maudoodi, Imam Muhammad Baqir al-Sadr, Anwar Iqbal Qureshi, Mohammad Nejatullah Sidiqi, Muhammad Uzair and Ahmad al-Najjar are amongst the pioneers of the Islamic banking movement.30


practical effort in the field of Islamic banking; his several other writings _A Suggestion For an Interest Free Islamic Monetary Fund_ (1955), and _Interest Free Lending Banks_ (1962) also belong to the above category.

Mohammad Uzair’s _An Outline of Interest less Banking_ (1955) has the distinction of being the first published work exclusively devoted to the subject of Islamic banking. His work _Factors Contributing to the Success of Interest Free Banks_ (1958) is also worth mentioning.

Muhammad Nejatullah Siddiqi’s _A Model of Interest Free Banking_ and _Ghair Sudi Bankari_ (Banking Without Interest, 1969) are considered few of the important contributions to Islamic banking in many respects. In his book Professor Siddiqi has dealt with bank model, creation and control of credit, consumer and government finance, and provision for short-term interest free loans to business. He has also introduced certain financial papers to replace bonds and securities. Some other mentionable works are summed up in the following table:

### Table No.1

**Some Early Writings on Islamic Economics and Banking**

<table>
<thead>
<tr>
<th>Writer</th>
<th>Title of the Book</th>
<th>Year of Publication</th>
<th>Language</th>
</tr>
</thead>
<tbody>
<tr>
<td>Naiem Siddiqui,</td>
<td><em>Islami Usool Par Banking</em></td>
<td>1948</td>
<td>Urdu</td>
</tr>
<tr>
<td>Maulana Abul A’la Mawdudi</td>
<td><em>Sood</em></td>
<td>1951</td>
<td>Urdu</td>
</tr>
<tr>
<td>Shaikh Ahmad Irshad</td>
<td><em>Bila Sood Bankari</em></td>
<td>1964</td>
<td>Urdu</td>
</tr>
<tr>
<td>Mohammad Akram</td>
<td><em>Islami Maishat Men Bank aur Bachaten</em></td>
<td>1965</td>
<td>Urdu</td>
</tr>
</tbody>
</table>
It may be noted that the majority of the second-generation writers on Islamic banking unlike first generation that mainly consisted of Ulama belonged to professional economists.

The period from 1930 to 1974 is characterized by theoretical writings on Islamic economics and banking, which can undoubtedly be described as the foundation period of Islamic banking. Most important writings of the period include Muhammad Uzair (1953), Mohammad Nejatullah Siddiqi 1961, 1969, Abdullah Ali Arabi, 1967, Baqir-al- Sadr 1961, 1974 and Ahmad-al-Najjar, 1971.31

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2.1.3.2 Seminars, Conferences, Committees and Institutions

Seminars and conferences have played a vital role in the concept, development and practice of the Islamic banking. In this regard Finance Minister’s conference in Karachi in 1970 and Egyptian study of 1972 are path breaking in many respects. However, it was the first International Conference on Islamic Economics held at Makkah 1976 that served as a catalyst at an international level and led to an exponential growth of literature on the subject. Islamic Fiqh Academy Seminar at Jeddah in the year 1985 is important in respect that a common definition of Riba was the outcome of this seminar i.e. a consensus on the definition of Riba that ended all previous speculation and controversies.

Islamic Finance Information Programme launched in Dec. 1995 has become a regular feature of Harvard University Forum. The seventh of such Islamic Finance Information Programme (HIFIP) has completed in April 2006. Proceedings of these programmes are published and available in the market. Institute of Islamic Banking and Insurance, London (1991) and Islamic Research & Training Institute (IRTI) of IDB Jeddah has made a significant contribution to the field of Islamic finance through research, publications, lectures, seminars, workshops and training courses.

During the last decade a number of institutions, bodies and centers were set up and scores of seminars, conferences on national and international levels were held on various aspects of Islamic banking & finance which had played important role in the development of the discipline and have become a regular feature since 1970s and kept the tempo of Islamic banking high.

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33 It can also be found at the website of Islamic Finance Project which is the continuation of HIFIP and the part of the Islamic Legal Studies Program (ILSP) at Harvard Law School. It aims to study the field of Islamic finance from the legal and shari’a points of view by analyzing contemporary scholarship, inducing collaboration among scholars within and outside the Muslim world, and increasing the interaction between theory and practice in Islamic finance. http://ifrtest.law.harvard.edu/ifshtml/
2.1.3.3 Compilation of Previous Works

Proper recording and compilation of previous works is important in many respects. It is an indicator of the direction and development of the subject. Few most important works in this field includes M. Akram’s, *Annotated Bibliography of Contemporary Economic thought in Islam* and *Glossary of Islamic Terms in Islam* prepared in 1973. It has compiled the work done in the field in English and Urdu languages. This bibliography was first published in 1983; another important work published in 1974 is done by Atiyah Jamal al-Din *“Dalil al Bahith fil Iqtisad al-Islami”* Arabic (A Guide to Researcher in Islamic Economics). One of the most popular work under this category was done by Muhammad Nejatullah Siddiqi34 *“A Survey of Contemporary Literature on Islamic Economics”* it was prepared in 1974 and published in 1980. Another important work by Muhammad Nejatullah Siddiqi, published in 1982 is *Recent Works on History of Economic Thought in Islam: A Survey*, this paper surveys the recent writings in Arabic, English and Urdu on the economic thinking of twenty seven eminent Islamic thinkers of the past from Imam Abu Hanifa to Allama Iqbal. M. A. Mannan’s *Abstracts of Researches in Islamic Economics*, 1984, is the listing of the works carried out by International Centre for Research in Islamic Economics (ICRIE) either independently or in collaboration with others. Nazim Ali and Nasim Ali (1994) have compiled the work *Information Sources on Islamic Banking and Economics 1980-1990*. This work covers the writings during the period of 1980 to 1990. *‘A Bibliography of Islamic Economics’* was also published by IRTI in 1993. One of the important additions into this line of work is *Islamic Economics & Finance A Bibliography* by Javed Ahmad Khan, published by Mansell, U.K. in 1995. Since then many have updated and extended such works with the latest literature review. This job is being regularly carried out by various noted journals and research institutions. *Muslim World Book Review* is one of

such academic magazines which regularly covers recent works on the subject of Islamic Economics, Finance & Banking.

2.1.3.4 Research Paper and Magazines

Various magazines and publications have become a regular feature on the subject of Islamic economics, finance and banking. Occasional papers, seminar proceedings published by various institutions like Islamic Research and Training Institute, (IRTI), Islamic Development Bank (IDB), The Islamic Foundation, UK, Center for Research in Islamic Economics, (CRIE) have played important role in disseminating the information on the discipline. Islamic Finance Project (IFP) of Harvard law school has become one of the important annual features for Islamic finance during the last few years. Some of the important magazines and journals on the subjects are; Review of Islamic Economics, UK, Islamic Economic Studies, Jeddah, King Abdul Aziz University Journal of Islamic Economics, Jeddah, American Journal of Islamic Finance, USA, New Horizon, Institute of Islamic Banking and Insurance, UK, Journal of Islamic Economics, Malaysia, Thoughts on Economics, Dhaka, Bangladesh, Journal of Islamic Banking and Finance, Karachi, International Journal of Islamic Financial Services (IIIFS) of IBF Net (now IBF review), Islamic Banking and Finance, Brighton, Islamic Business & Finance of CPI Financial, Dubai and Islamic Finance Today, Sri Lanka etc.

2.1.3.5 Research Institutions and Professional Associations

Several organizations and research institutes have played important role in the development of concept and practices of Islamic banking. One of the main institutions supporting Islamic Financial Service Industry (IFSI) has been the Islamic Development Bank (IDB) that initiated the establishment of the first infrastructure

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35 Islamic Fiqh Academy, Jeddah (1981), The Association of Muslim Social Scientist, U.S.A. (1972); the Islamic Foundation, Leicester, U.K. (1973); Islamic Economics Research Bureau, Dhaka, Bangladesh (1976); the Center For Research in Islamic Economics, the King Abdul Aziz University, Jeddah (1977); the International Institute of Islamic Thought, Herndon, Virginia, U.S.A. (1981); the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (1983); the International Institute of Islamic Economics, Islamabad (1983); the International Association for Islamic Economics (1984).
institution the Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI), followed by a group of infrastructure institutions each of them is specialized in a specific field serving IFSI. This group of institutions comprises of the General Council for Islamic Banks and Financial Institutions (CIBAFI), the International Islamic Financial Market (IIFM), the Islamic Financial Services Board (IFSB), the International Islamic Rating Agency (IIRA) etc. Few of such organizations devoted specifically to the cause of Islamic banking practices are mentioned blow:

(i) The International Association of Islamic Banks (IAIB)\(^{36}\): established in 1977 by the Islamic Development Bank. This association is playing an important role in the meeting of central banks and monetary agencies of the Islamic countries as well as the meetings of the specialized bodies of the OIC in the field of banking and insurance. The association aims to strengthen ties between Islamic financial institutions, fostering cooperation, coordinating their activities and monitoring their operations to insure that they conform to the Shari'ah. It provides technical assistance and expertise to the people wishing to establish Islamic banks. It also represents the common interests of Islamic banks at national and the international level. Now CBAFI has taken its form to involve specifically in few of these activities.

(ii) Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI): is a self-regulated organization founded by Islamic banks worldwide in 1991. It is striving to regularize accounting standard across Islamic banking. It has established sixteen accounting standards, four on accounting, and three on governance. It has also started issuing Shari‘ah standards.

(iii) Institute of Islamic Banking and Insurance (IIBI): Established in 1993 to render a service to Islamic banking & insurance. The institute offers a diploma course

\(^{36}\) It has now been merged and renamed as The General Council for Islamic banks and Financial institution.
in Islamic banking and insurance and publishes a monthly called *New Horizon*. Its main objectives are as follows:

1) Promotion of knowledge of Islamic banking and insurance through conferences, seminars, lectures and publications.

2) Education of personnel in Islamic banking & insurance.

3) Assistance and advice on all aspects of Islamic banking & insurance.

4) Development of Islamic financial institutions.

5) Study and research on issues and problems in the field of Islamic banking & insurance.

(iv) Islamic Financial Services Board (IFSB): A Malaysia based organization is recently established by the Islamic Development Bank (IDB), Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI) with the active collaboration of the International Monetary Fund (IMF). According to IMF sources the IFSB will serve as an association of institutions that have responsibility for the regulation and supervision of the Islamic financial services industry and will:

I. Set and disseminate standard and core principles as well as adapt existing international standards for supervision and regulation, consistent with the *Shariah*.

II. Liaise and cooperate with other standard setters in the areas of monetary and financial stability.

III. Promote good practices in risk management in the industry through research, training and technical assistance.\(^{37}\)

2.2 Specific Review

2.2.1 Islamic Modes of Finance

\(^{37}\) *International Monetary Fund*, News Brief, No. 02/41, May 1, 2002.
Bahgat Khalil El Sharif (1990)\textsuperscript{38} in his dissertation highlights in detail, conditions of mudarabah under the major doctrines of Islamic Shariah: conditions relating to the parties and capital; sharing of risks and profits, and other important features of mudarabah. It also undertakes a detailed examination of Murabahah and its features in the Islamic legal framework. His study investigates the current practices of Islamic banks relating to mudarabah and murabahah and their degree of conformity to the classical Islamic legal framework.

Prof Siddiqi (1992)\textsuperscript{39} in his writing focuses on the different perceptions about the likely impact of Islamic banks' operations on money supply. Since investment accounts with the Islamic banks carry some withdrawal facility, new money is created when the funds in these accounts go to entrepreneurs on profit-sharing or Murabahah basis. The paper argues that as compared to the conventional banks money creation by Islamic banks is more closely associated with the creation of additional wealth in the real sector. The resulting expansion in money supply will be smaller compared to that resulting from conventional banks' lending out of their time and saving deposits. The Islamic banks should, therefore, be subjected to a reserve ratio smaller than that applied by the central bank to the conventional banks.

Fahim Khan (1992)\textsuperscript{40} provides in his paper a comparison to the economic features of different modes of Islamic financing and discusses the effect and benefit from the application of these modes. The permissibility and availability of a variety of modes of financing with different economic implications has been elaborated.

\textsuperscript{38} El Sharif, Bahgat Khalil Law and Practice of Profit-Sharing in Islamic Banking with Particular Reference to Mudarabah and Murabahah.


\textsuperscript{40} Khan, M. Fahim, ‘Comparative Economics of Some Islamic Financing Techniques’ IRTI/IDB
Ausaf Ahmad (1993)\textsuperscript{41} in his work analyses Islamic financing techniques used by various Islamic banks and explores differences, if any, in the use of these financing techniques by these banks.

Tarek S. Zaher & M. Kabir Hassan (2001)\textsuperscript{42}, in their paper though, provides a comprehensive comparative review of the literature on the Islamic financial system but specifically deals with the basic features of the Islamic finance and banking and Islamic financial instruments in order to compare them to existing Western financial instruments and discuss the legal problems that investors in these instruments may encounter. The paper also gives a preliminary empirical assessment of the performance of Islamic banking and finance, and highlights the regulations, challenges and problems in the Islamic banking market.

Iqbal and Llewellyn (2002)\textsuperscript{43} argued that the modes of financing used by Islamic banks are, however, unique for two reasons. First, debts associated with financing by way of mark-up modes results from real commodity sale/purchase operations, rather than the exchange of money for interest-bearing debt. Second the introduction into banking of modes that depend on profit sharing is an innovation that brings important advantages.

However, large number of works available discusses Fiqhi and economic issues concerning Islamic modes of finance and is mostly confined to critical comment on the observed practice of Islamic banks. Various literature survey the historical evolution of Islamic method of Financing.

2.2.2 Murabahah:

\textsuperscript{41} Ahmad, Ausaf, ‘Contemporary Practices of Islamic Financing Techniques’, IRTI/IDB, Jeddah.
\textsuperscript{42} Zaher, Tarek S. & M. Kabir Hassan, ‘A Comparative Literature Survey of Islamic Finance and Banking’, IRTI/IDB.
Sami Hasan Hamoud (1976) in his Ph. D. thesis first introduced the concept of “Murabahah lil ‘Amir bil Shira” in contemporary Islamic finance, based on a fatwa by Sheikh Faraj al-Sanhuri. Banking finance based on the classical Mudarabah principle has been challenged by Hamoud & others. He pointed out some limitations of classical Mudarabah principle in its application to the modern needs of financing and suggested a proposal as other alternatives to them. In his work, he invited attention to the cases where Mudarabah is incapable to provide financing e.g. consumer’s goods, (durable or non durables), goods supplied to government and industry etc. He was in search of an Islamically acceptable financial instrument capable of competing with conventional consumer-finance product. Thus since the publication of Hamoud (1982) Murabahah emerged as a principle distinct from sharing one (PLSP) and became the backbone of contemporary Islamic Finance. Islamic banks welcomed this new addition from fiqh that allowed them to replace a significant part of their practice of high risk amanah financing such as Mudarabah & Musharakah. Sami developed this concept on the basis of Imam Shafi‘i’s concept of al-Murabahah.

Dr. Abdul Hameed al- Ba‘ali in his book dilates upon Murabahah contract from legal (fiqhi) perspective covering the opinions of all four famous schools of Classical Jurisprudence viz. Hanafi, Maliki, Shafi‘I and Hanbali including Zahiri. The work has a good discourse on different aspects and issues of Murabahah with all possible fiqhi discussion. While concluding the debate, the author does the comparative analysis among different opinions and thereby establishes a favouring opinion. There is also juristic analysis on contemporary issues of Murabahah.

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• Dr. Yusuf al-Qaradawi (1984) in his writing, has successfully dealt with the critique & arguments put forth against contemporary Murabahah and tried to remove the objections with legal evidences deduced from Qur’anic verses, Sunnah & other sources of shariah including logical reasoning. He first presented the opponent views and their arguments then did the critical appraisal of their viewpoints and pointed out the underlying weakness in their standpoint and thereafter clarified the confusion that led to misconception related to contemporary Murabahah. He is very clear in his argument. His work discusses the nature and form of Murabahah contract and its peculiarities and elaborately deals with one of the most important issues of contemporary Murabahah i.e. whether the promise is binding or non-binding on the part of promisor (client). Dr. Qaradawi argues in favour of binding nature of promise by putting forth the arguments of both earlier scholars and later ones. Dr. Rafiq al-Misri had strong reservation in this behalf and hence put a rebuttal to binding Murabahah and argued for non-binding Murabahah. He critically examined the arguments and points put forth by Yusuf al-Qaradawi. Qaradawi then clarified more the issue in question and tried to spell out the picture on the matter referring to the objections of al-Misri.

• Ahmad Ali Abdullah (1987) in his work has tried to touch all concerning issues of Murabahah and its contemporary application & practices and analyse them in fiqhi perspective taking into account the opinions of various schools of jurisprudence including Zahiri & Shi’ites. The author also critically analyses the legal opinions and argues for convincing one. The second chapter of the book is very significant in the sense that it deals at length with contemporary Murabahah, its concerns and important aspects. The various misconceptions and objections raised against Murabahah have been dealt in the light of legal opinions of classical fiqaha.

• Jamal Attieh (1990)\textsuperscript{48} in his work highlights legal problems that arise in implementing Murabahah (mark-up) contract as a financing tool that is widely used by Islamic banks. He argues that major problem is the question of bank ownership of the financed commodity. This ownership is required by shari‘ah but prohibited by banking laws in many countries. Exempting Islamic banks from such laws-as has often been the case-and referring them to fiqh leaves important legal gaps, because fiqh encompasses several and occasionally opposite views. He also discusses a bank's rights and obligations in case of traditional letter of credit as compared to Murabahah and concludes with suggested solutions to the problems raised. Some suggestions require specific changes in laws, while others may be adopted by individual banks.

• Dr. Attieh Fayyaz (1999)\textsuperscript{49} deals rather much in detail with the subject of Murabahah. He has elaborately discussed ordinary and contemporary Murabahah with pros and cons in the light of Islamic law (fiqh). His work covers various important issues related to Murabahah like promise to purchase & its bindingness, conditions for validity of the specific form of contemporary Murabahah, expenses in relation to Murabahah, increased price due to deferred payment, rebate on earlier payment, the issue of providing securities and guaranteeing, financial discount in the case of paying installment on time etc. In short, his work provides a full discourse on each aspect of the subject.

• Yusuf Talal DeLorenzo (1997)\textsuperscript{50} has compiled a useful compendium of legal opinions (fatwa) on the operations of Islamic banks based on the Arabic fatwa having English translation with original Arabic text. Its chapter on Murabahah classifies the questions and answers in terms of contract components, contract


provisions, and the contract itself and the prohibited cases. In view of Murabahah being prevalent and termed as a suspect contract, this chapter includes about 70 percent of the questions and fatwas of the compendium. However, different and opposing opinions were not presented on the issues in question. If it is so, it would prove to be very useful and valuable in order to appreciate the matter in depth.

- M. Taqi Usmani, (2000) in his work has analysed various important issues of contemporary Murabahah from legal, logical and economic point of view in clear, simple and convincing way. Being a shariah advisor of a number of Islamic Banks with substantial experience of their working, he provides a thoughtful and pertinent analysis on the subject taking cognizance of the realities of present times. For proper understanding the issues, he discusses them in the light of the authoritative texts of Shariah sources and the lessons learnt from Islamic Banking experiment. He has more innovative approach to ijtihadi matters without disregarding the traditional juristic opinions but he does not follow the unambitious approach often adopted by Muslim scholars with regard to the prohibition set by shari‘ah concerning financial matters. He gives the reasons which justify these prohibitions, instead of merely raising them and shielding behind them without providing an explanation. He does not also hesitate to warn where necessary, e.g. he points out that that using Murabahah and Ijarah as modes of financing is not what these two concept were meant for and therefore, when they are applied outside their original purpose, additional requirements must be fulfilled. His work relies substantially on classical Arabic sources with logical interpretation and thus it is one of the best reference on the subject available in English language.

Some booklets, articles and conference paper specific to Murabahah have been written in English and Urdu languages. But to my little knowledge, a comprehensive work in English on the subject from the legal (fiqhi) and economic point of view with empirical evidence as in the case of PLS financing modes has not

be attended so far. There might be some good works of contemporary scholars on the subject but the researcher is not aware of them till date.

There are numerous articles and conference paper dealing specifically issues of contemporary Murabahah financing such as legal aspect, risk default in payment, viability for short, medium & long terms finance, practical aspects, problems & difficulties and controversial issues relating to Murabahah, time value of money in deferred Murabahah etc.

2.3 Fundamentals and Some Basic Issues:

Much of what follows is borrowed from other writings as it is the restatement of the well-known facts.

2.3.1 Islamic Finance and Conventional Finance:

Prohibition of interest has not been the only factor responsible for the development of Islamic banking. Banking is just a part of overall economic system whether conventional or Islamic. Failure of the conventional economic theories to resolve out many contemporary problems like unemployment, inflation, increasing income inequality, along with the falling down of the myth of Philip’s curve, and many time conflicting objectives of the conventional economic theories escorted the Muslim thinkers to reconstruct the objective of economics as subject of social science. Chapra, a research advisor at Islamic Research and Training Institute (IRTI), submits that continued deviation of the conventional economics from normative to positive approach resulted in many conflicting objectives like:

A. Harmony between individual preference and social interest
B. Equal distribution of income and wealth.
C. Reflection of the urgency of wants by prices.

52 The recent experiences of stagflation, high rates of unemployment existing simultaneously with high rates of inflation has raised serious doubts about the validity of the Philip’s curve, which postulated a stable tradeoff between inflation and unemployment.
D. Perfect competition

Chapra argues that market forces, not like the presuming conventional economists, may not always be in harmony between the individual preference and the social interest. He cites the case of pollution, which is social cost to the society and any efforts to reduce it would violate the condition of Pareto’s optimality. He also asks why conventional economics does not take into account the social costs resulting from bank of need fulfillment, unemployment, inequitable distribution and economic instability.

Inequality in income and wealth tend to be biased in favor of rich at the cost of poor. This diverts the scarce national resources in favor of production of status symbol, inessential unproductive goods at the cost of socially preferable need fulfilling items. For example Arthur Okun remarked that market tend to award prizes that allow the big winners to feed their pets better than the losers can feed their children.54

The reason given by Chapra behind the market failure in his own word is that, “the secularist paradigm has led to an excessive commitment to neutrality between ends, abstinence from value judgments and choice primarily through the market” which is not in conformity with the needs of goal realization.55

Contrary to this, Islamic economics is based on a paradigm, which has socio-economic as its primary objective. This objective takes its roots in the belief that human beings are the Vicegerents of the one Allah, who is the creator of the universe and every thing in it. They are brothers unto each other and all resources at their disposal are a trust from Him to be used in a just manner for the well being of all. They are accountable to Him in the hereafter and will be rewarded or punished for how they acquired and used these resources. In Islamic economics the human beings are not considered to be dependent primarily on maximizing wealth and

consumption, rather it requires a balanced satisfaction of both the material and spiritual needs of the human beings. The fundamental difference between both the economic systems is well represented in their respective banking systems.

An International Monetary Fund study by Iqbal and Mirakhor\textsuperscript{56} has found Islamic banking to be a viable proposition that can result in efficient resource allocation. The study suggests that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts. The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope.

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. According to Abbas Mirakhor:

"[An] important function of Islamic finance that is seldom noted ... is the ability of Islamic finance to provide the vehicle for financial and economic empowerment ... to convert dead capital into income generating assets to financially and economically empower the poor ..."\textsuperscript{57}

\textsuperscript{56} Iqbal, Zubair and Mirakhor, Abbas (1987), Islamic Banking, Occasional Paper 49, International Monetary Fund, Washington D.C.

\textsuperscript{57} Mirakhor, Abbas (2002) Hopes for the Future of Islamic Finance (Lecture at the Institute of Islamic Banking, London)
Development is promoted through various business practices and almsgiving (zakat). Conventional finance typically focuses on profit-maximization within a given regulatory framework, whereas Islamic finance is also guided by these other Islamic principles.

The special characteristics of Islamic finance can provide alternative means to reaching underserved groups such as small, rural, and agricultural producers. Projects that could be turned down by conventional banks due to a lack of collateral, may be financed by Islamic banks on a profit-sharing basis. In this regard, Islamic finance can catalyze economic development and reduce poverty.

Conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on the one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money.58

Islam, on the other hand, considers a loan to be given or taken, free of charge, to meet any contingency. Thus in Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, more often it happens that it leads to some kind of injustice. The first Islamic principle underlying such kinds of transactions is that “deal not unjustly, and ye shall not be dealt with unjustly”.59 Hence, commercial banking in an Islamic framework is not based on the debtor-creditor relationship.

The second principle regarding financial transactions in Islam is that there should not be any reward without taking a risk. This principle is applicable to both labor and capital. As no payment is allowed for labor, unless it is applied to work, there is no reward for capital unless it is exposed to business risk.60 Thus, financial intermediation in an Islamic framework has been developed on the basis of the above

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59 Al-Qur’an, 2:279
two principles. Consequently financial relationships in Islam have been participatory in nature. Several theorists suggest that commercial banking in an interest-free system should be organized on the principle of profit and loss sharing. The institution of interest is thus replaced by a principle of participation in profit and loss. That means a fixed rate of interest is replaced by a variable rate of return based on real economic activities.\footnote{Mangla, I. Y., and Uppal, J. Y. (1990). “Islamic Banking: a Survey and Some Operational Issues”. Research in Financial Service, New York: McGraw-Hill. Vol. 2, pp. 179-215, 185}

Unlike conventional banks which rely on documentary evidence and usually have impersonal, arms-length, passive relationships with the majority of their clients, Islamic banks have more stringent Know-Your-Customer requirements. The reason for this difference is quite commonsensical. Conventional banks rely on a fixed predetermined return framework and are, therefore less concerned about the character and credibility of their clients. They are often, more pre-occupied with the underlying securities and assets. On the other hand, Islamic banks are engaged in a quasi-partnership profit-loss sharing framework and therefore have to know their clients, their businesses, as well as, their sources and uses of funding in order to satisfy themselves about the authenticity and legitimacy of their counterparties. Thus, they would be in a much better position to detect, prevent and disengage quickly from suspicious transactions compared to conventional banks. In addition to normal audits, Islamic banks have to conduct Shari’ah review of their transactions for ensuring Shari’ah compliance. This review will catch any funds mobilized or used for haram (prohibited) activities.

To be brief, the main difference between the present economic system and the Islamic economic system is that the later is based on keeping in view certain social objectives for the benefit of human beings and society. Islam, through its various principles, guides human life and ensures free enterprise and trade. That is the reason why the conventional banker does not have to be concerned with the moral implications of the business venture for which money is lent.
The Islamic financial system is based on equity whereas the conventional banking system is loan based. Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another.\footnote{Alam, Mohammed N. (2003) "A Comparative Study between Islamic and Conventional Banking Systems. A study based on an Institutional-network theoretical framework".}

2.3.2 Pre-requisites of Islamic Finance

The simple rules regarding Islamic finance can be summed up as follows:

a) Any predetermined payment over and above the actual amount of principal is prohibited.

Islam allows only one kind of loan and that is \textit{al-qard al-hasan} (literally good loan) whereby the lender does not charge any interest or additional amount over the money lent. Traditional Muslim jurists have construed this principle so strictly that, according to one commentator "this prohibition applies to any advantage or benefits that the lender might secure out of the \textit{qard} (loan) such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall." The principle derived from the quotation emphasizes that associated or indirect benefits are prohibited.

In short, the prohibition of usury or interest (\textit{riba}) is the most significant principle of Islamic finance. \textit{Riba} translates literally from Arabic as \textit{an increase, growth or accretion}. In Islam, lending money should not generate unjustified income. As a \textit{Shari'ah} term, it refers to the premium that the borrower must pay to the lender along with the principal amount, as a condition for the loan or for an extension in its maturity, which today is commonly referred to as interest.

\textit{Riba} represents a prominent source of unjustified advantage. All Muslim scholars are in consensus that this prohibition extends to all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption
or investment, because *Sharia* does not consider money a commodity for exchange. Instead, money is a medium of exchange and a store of value.

Thus the prohibitions against interest aim to promote justice in distribution. Islamic law does not distinguish between high rates of interest (characterized as usury) and lower rates. Any excess over and above the sum lent is disallowed.

**b) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.**

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. As defined in the Shari'ah, or Islamic law, Islamic finance is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower: he must pay back his loan, with the agreed interest, regardless of the success or failure of his venture.

The principle which thereby emerges is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent). Accordingly, under Islam, either people invest with risk or suffer loss through devaluation by inflation by keeping their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors. The objective is that high risk investments provide a stimulus to the economy and encourage entrepreneurs to maximise their efforts.
c) Making money from money is not Islamically acceptable.
Money is only a medium of exchange, a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle so that, for instance, hoarding money is regarded as being unacceptable. In Islam, money represents purchasing power which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

d) *Gharar* (Uncertainty, Risk or Speculation) is also prohibited.
Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains' which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials.

A number of Islamic scholars disapprove the indexation of indebtedness to inflation and explain this prohibition within the framework of qard-el-hassan. According to those scholars, the creditor advances the loan to win the blessings of
Allah and expects to obtain the reward from Allah alone. A number of transactions are treated as exceptions to the principle of gharar: sales with advanced payment (bai‘ bithaman ajil); contract to manufacture (Istisna); and hire contract (Ijara). However, there are legal requirements for the conclusion of these contracts to be organised in a way which minimises risk.

e) Investments should only support practices or products that are not forbidden—or even discouraged—by Islam. Trade in alcohol, for example would not be financed by an Islamic bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest.

A set of prohibitions on which Islamic finance paradigm is based can be summed up as follows:

i) Transactions in unethical goods and services;

ii) Earning returns from a loan contract (Riba/Interest);

iii) Compensation-based restructuring of debts;

iv) Excessive uncertainty in contracts (Gharar);

v) Gambling and chance-based games (Qimar);

vi) Trading in debt contracts at discount, and;

vii) Forward foreign exchange transactions.

2.3.3 Distinguishing Features of Islamic Banking

An Islamic bank has several distinctive features as compared to its conventional counterpart. Chapra has outlined six essential differences as below:63

a) Abolition of interest (Riba): Since Riba is prohibited in the Quran and interest in all its forms is akin to Riba, as confirmed by fiqaha and Muslim

economists with rare exceptions, the first distinguishing feature of an Islamic bank must be that it is interest-free.

b) **Adherence to public interest:** Activity of commercial banks being primarily based on the use of public funds, public interest rather than individual or group interest will be served by Islamic commercial banks. The Islamic banks should use all deposits, which come from the public for serving public interest and realizing the relevant socio-economic goals of Islam. They should play a goal-oriented rather than merely a profit-maximizing role and should adjust themselves to the different needs of the Islamic economy.

c) **Multi-purpose bank:** Another substantial distinguishing feature is that Islamic banks will be universal or multi-purpose banks and not purely commercial banks. These banks are conceived to be a crossbreed of commercial and investment banks, investment trusts and investment-management institutions, and would offer a variety of services to their customers. A substantial part of their financing would be for specific projects or ventures. Their equity-oriented investments would not permit them to borrow short-term funds and lend to long-term investments. This should make them less crisis-prone compared to their capitalist counterparts, since they would have to make a greater effort to match the maturity of their liabilities with the maturity of their assets.

d) **More careful evaluation of investment demand:** Another very important feature of an Islamic bank is its very careful attitude towards evaluation of applications for equity oriented financing. It is customary that conventional banks evaluate applications, consider collateral and avoid risk as much as possible. Their main concern does not go beyond ensuring the security of their principal and interest receipts. Since the Islamic bank has a built in mechanism of risk sharing, it would need to be more careful in how it evaluates financing requests. It adds a healthy dimension in the whole lending business and eliminates a whole range of undesirable lending practices.
e) Work as catalyst of development: Profit-loss sharing being a distinctive characteristic of an Islamic bank fosters closer relations between banks and entrepreneurs. It helps develop financial expertise in non-financial firms and also enables the bank to assume the role of technical consultant and financial adviser, which acts as catalyst in the process of industrialization and development.

For the sake of simplicity, the distinguishing features of the conventional banking and Islamic banking are shown in terms of a box diagram as shown below:

### Table-2

**Comparison Between Conventional & Islamic Banks**

<table>
<thead>
<tr>
<th>Conventional Banks</th>
<th>Islamic Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The functions and operating modes of conventional banks are based on manmade principles.</td>
<td>1. The functions and operating modes of Islamic banks are based on the principles of Islamic <em>Shariah</em>.</td>
</tr>
<tr>
<td>2. The investor is assured of a predetermined rate of interest.</td>
<td>2. In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).</td>
</tr>
<tr>
<td>3. It aims at maximizing profit without any restriction.</td>
<td>3. It also aims at maximizing profit but subject to <em>Shariah</em> restrictions.</td>
</tr>
<tr>
<td>4. It does not deal with <em>Zakat</em>.</td>
<td>4. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to collect and distribute <em>Zakat</em>.</td>
</tr>
<tr>
<td></td>
<td>5. Leading money and getting it back with interest is the fundamental function of the conventional banks.</td>
</tr>
<tr>
<td>---</td>
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</tr>
<tr>
<td></td>
<td>6. Its scope of activities is narrower when compared with an Islamic bank.</td>
</tr>
<tr>
<td></td>
<td>7. It can charge additional money (compound rate of interest) in case of defaulters.</td>
</tr>
<tr>
<td></td>
<td>8. In it very often, bank’s own interest becomes prominent. It makes no effort to ensure growth with equity.</td>
</tr>
<tr>
<td></td>
<td>9. For interest-based commercial banks, borrowing from the money market is relatively easier.</td>
</tr>
<tr>
<td></td>
<td>10. Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.</td>
</tr>
<tr>
<td></td>
<td>11. The conventional banks give greater emphasis on credit-worthiness of the clients.</td>
</tr>
<tr>
<td></td>
<td>5. Participation in partnership business is the fundamental function of the Islamic banks.</td>
</tr>
<tr>
<td></td>
<td>6. Its scope of activities is wider when compared with a conventional bank. It is, in effect, a multi-purpose institution.</td>
</tr>
<tr>
<td></td>
<td>7. The Islamic banks have no provision to charge any extra money from the defaulters.</td>
</tr>
<tr>
<td></td>
<td>8. It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.</td>
</tr>
<tr>
<td></td>
<td>9. For the Islamic banks, it is comparatively difficult to borrow money from the money market.</td>
</tr>
<tr>
<td></td>
<td>10. Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.</td>
</tr>
<tr>
<td></td>
<td>11. The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.</td>
</tr>
</tbody>
</table>
12. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.  
12. The status of Islamic bank in relation to its clients is that of partners, investors and trader.  
13. A conventional bank has to guarantee all its deposits.  
13. Strictly speaking, and Islamic bank cannot do that.

<table>
<thead>
<tr>
<th>2.3.4 Acceptability of Dealing with Islamic Financial Institutions:</th>
</tr>
</thead>
<tbody>
<tr>
<td>As we have seen, Islamic financial institutions abide by the permissible transactions in shari‘ah and avoid the forbidden transactions. Moreover, they serve a vital economic need of the poor in the economy, while providing a valuable service in mobilizing savings and encouraging investment and growth in the economy.</td>
</tr>
</tbody>
</table>

It is well known that the original status of all economic contracts is permissibility unless ruled otherwise. Thus, since the transactions of Islamic financial institutions are far from the forbidden riba, and they provide useful economic tools to meet the economic needs of Muslims, they are permissible. In this regard, shari‘ah does not forbid anyone from making reasonable profits (up to 20% or 33%). While some people doubt that certain types of profits made from Islamic banks may seem similar to riba, we note that as long as the means used to obtain those profits are permissible, the transactions are permissible. Thus, while some may argue against the increase in price for deferment in Murabahah contract, we say that the Muslim jurists permitted such transactions to meet the economic needs of Muslims. Such contracts are not exploitative, on the contrary, they help the consumer to obtain goods that he would not otherwise be able to consume.

Similarly, commissions and fees that Islamic financial institutions charge for their services may be thought by some to be forbidden riba. However, most of the activities of those institutions take the form of rental (e.g. of a deposit box or storage room) and hiring of labor services (e.g. in maintaining such space, or preparing
paperwork for transactions), or agency in exchange for a fee. All such fees and commissions are permissible and should not be confused for the forbidden riba.

For structural differences between the financial characteristics of interest-free banks and conventional banks, see M.M. Metawali (1997). In his paper, covering 15 interest-free banks and 15 conventional banks, the analysis extends to various financial dimensions which evaluate performance, namely: liquidity, leverage, credit risk, profitability and efficiency. And the statistical evidence suggests that the two groups of banks may be differentiated in terms of liquidity, leverage and credit risk, but not in terms of profitability and efficiency.

2.3.5 The Advantages of Islamic Finance:

Justice and fairness to all concerned is the main feature of a model of financial intermediation whose core is profit-sharing. Interest is essentially unfair because our environment does not guarantee positive returns to business enterprise financed with borrowed money capital. Current practice penalizes entrepreneurship by obliging it to return the principal even when part of it is lost due to circumstances beyond the entrepreneur's control. Justice requires that money capital seeking profit share the risk attached to profit-making. A just system of financial intermediation will contribute to a more equitable distribution of income and wealth.

Islamic finance will foster greater stability as it synchronizes the payment obligations of the entrepreneur with his revenues. This is possible only when the obligation to pay back the funds acquired from the financier and also pay a profit is related to the realization of profits in the project in which the funds are invested, as is the case in the profit-sharing model.

In contradiction to this, in the debt-financing model the payment obligations of the entrepreneur are dated and fixed in amount. The same is true for financial

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intermediaries, whose commitment to the depositors in time and savings accounts is to pay back the sum deposited with interest added. When a project fails and a business person defaults, the financial intermediary must also default, and the ripple effects destabilize the whole system. The debt-based financial system of capitalism is inherently prone to recurrent crises. This malaise of the capitalist financial system is well discussed by Hyman P Minskey.\footnote{Minskey, Hyman P. (1986), "Stabilizing an Unstable Economy" (New Haven and London, Yale University Press).} By linking the depositors’ entitlements to the actual profitability of the projects in which their monies are invested through the services of the financial intermediary, a bank would almost eliminate the risk of runs on the bank insofar as the investment accounts are concerned. A report or a rumor that the bank’s investments were not doing well would not prompt a rash of withdrawals from investment accounts, since depositors would only be able to get what was actually salvageable. A more rational option would be to wait until the situation improved.

Islamic finance is more efficient in that it allocates investable funds on the basis of the expected value productivity of projects rather than on the criterion of the creditworthiness of those who own the projects, which is the case in debt-based finance. There is no guarantee that the most promising projects seeking finance will come from the most wealthy. Indeed, the most innovative may be empty-handed, but debt finance does not serve them. It prefers those who, on the basis of other assets they own, are able to pay back the sum borrowed with interest added, even when the project being financed fails to create additional wealth.

Finally, Islamic finance is less prone to inflation and less vulnerable to speculation, which are currently being fueled by the presence of huge quantities of debt instruments in the market. Debt instruments function as money substitutes, while equity-based financial instruments do not. And speculators find it much easier to manipulate debt instruments than those based on profit-sharing.
It is true that these advantages belong to a system whose core is profit-sharing. But even Murabahah (cost-plus or mark-up) financing keeps the system far less vulnerable to inflation and gambling (e.g., speculation) than do conventional debt-based arrangements. Murabahah is firmly linked with the exchange of real goods and services. It is a price, to be paid later. It is essentially different from money given as a loan which may or may not be linked to the production or exchange of real goods and services. An Islamic system of finance in which profit-sharing and mark-up financing exist side by side will still retain the advantages noted above.66

Mabid Ali al-Jarhi, Islamic Research and Training Institute has classified some advantages of Islamic Finance under different heads examining Islamic finance from several sides such as efficiency, stability, moral hazard and adverse selection, role in economic development, integrity, equity and sustainability that are as follows67:

1) Efficiency

At the macroeconomic level, Islamic finance avoids the use of interest-based lending. The rate of interest is replaced by the rate of profit on equity and profit-sharing finance, by markups on credit-purchase finance and by rental rates on leasing finance. While the time-value of money is maintained, there is no need to handle the complicated questions of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources.

Conventional finance allocates financial resources with paramount regard for borrower’s ability to repay loan principal and interest. In modes of Islamic finance that are based on equity and profit-sharing, focus would be on the profitability and rate of return of the concerned investment. This type of finance has the potential of

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directing financial resources to the most productive investments. This would increase the efficiency of the financing process and reinforce efficiency in the real sectors.

2) Stability

A conventional bank has on the one hand liabilities that include demand, time and saving deposits, which the bank guarantees. On the other hand, it has assets that are mostly composed of debt instruments each of which has a quality that depends on the ability of the corresponding debtor to repay. Default on the asset side, if it happens in significant proportion, would imply inability to meet the bank’s obligations on the liability side. Such default can be expected at times of crises, be it of macroeconomic nature or caused by circumstances specific to the bank. A bank operating according to Islamic rules of finance has liabilities of different nature. Only demand deposits are guaranteed. Meanwhile, investment deposits are placed on profit-and-loss sharing basis. When such bank faces macroeconomic or specific crises, investment depositors automatically share the risk. The bank is less likely to fall and a bank run is less probable. It can therefore be said that an Islamic banking system is relatively more stable when compared to conventional banking.68

In conventional finance, present money is traded in an integrated debt market against future money, which takes the shape of commitments to pay specified amounts at specified future dates, or bonds. Bonds are supposed to be easily traded financial instruments, many of which are listed in international financial markets. Hundreds of billions of dollars of debt are traded daily in those markets. Bonds markets provide an easy and automatic mechanism through which short-term funds flow at will from one country to another. Much of those flows follow factors that are only nebulously related to economic fundamentals. They bring an important element of instability into national economies. They threaten the world economy with the spread of instability that might start in one single debt market in a fashion that economists have come to call “contagion”.

The integrated debt market has grown immense in size as well as in scale of integration that now encompasses the whole world economy. Many experiences, as lately manifested in the Southeast Asian economies, have shown that integrated debt markets are sources of both domestic financial instability and contagion. Some economists have come forward with proposals to place restrictions on capital movements in contrary with what has been considered in economics as received doctrine.

In contrast, debt is created in Islamic finance through selling goods and services on credit. Resulting debt instruments are not readily tradable. We can visualize the existence of a credit market for each commodity and service in which the demand and supply to buy it on credit determines a mark-up rate. Such credit markets would be fully segmented, while the debt instruments themselves are traded only for nominal values at maturity. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion through the debt market would therefore be remote and the justifications to choke capital movements with restrictions become unnecessary.

Examination of daily records of trading in financial markets vividly shows that institutional participants carry out huge speculative transactions. More often than not, such transactions are sources of instabilities. In contrast, Islamic financial institutions are automatically prevented from carrying out such gambling activities; destabilizing speculations would be significantly curtailed in financial markets.

We have noted above that Islamic finance never provides present money in return for future money. All Islamic modes of finance involve money on the one end and goods and services on the other. Monetary flows through Islamic financial modes would have to be tied directly with commodity flows. In other words, Islamic finance removes the dichotomy between financial and real activities. Obviously, this leaves

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69 At maturity both counter-values, viz., debt and its nominal value would be spot and equal in amount, thereby fulfilling the necessary conditions for trading money in Islam. Meanwhile, debt can be swapped against tangible goods or services (according to Imam Malik and Ibn Taymiah), but not for cash.
little room for excessive credit expansion, as the finance extended is automatically earmarked for specific uses.

Speculative activities related to interest rate expectations would become out of place. Changes in spending would automatically be reflected on changes in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces. In other words, markets are more likely to operate efficiently and smoothly. It is therefore interesting to note that Islamic finance, though non-conventional, supports market forces and mechanisms more than does conventional finance.

3) Moral Hazard and Adverse Selection

We have mentioned above that Islamic banks hold equity and trade in goods and services as they operate as universal rather than commercial banks. Universal banks are defined as “large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters”.

A bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced. This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform.

Obviously, adverse selection can be avoided by careful screening of finance applicants. When a bank provides equity and debt finance simultaneously, it will have more access to information than when only debt finance is provided. We can therefore conclude that screening would be more effective and adverse selection less probable with universal banking.

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Reducing possibilities of moral hazard requires monitoring the firm that obtains finance. All three kinds of ex ante, interim and ex post monitoring must be exercised to be effective. Equity finance provides the bank with access to information necessary to practice monitoring at all intervals. It also reduces the firm incentives to substitute riskier for safer assets. Meanwhile, debt finance would reduce the firm incentives to hide its profits. Furthermore, when the firm faces problems, the bank, as an equity holder, will assist in order to protect its investment.

In summary, banking theory indicates that universal banking would be exposed to lower levels of moral hazard and adverse selection. In addition, by sitting on the firms' board of directors, banks could influence corporate governance in the whole productive sector, leading to improvements in economic performance.

Empirically, it has been found that using a combination of debt and equity finance by banks seems to carry several advantages to both banks and firms, confirming theoretical findings. Banking theory would indicate that banks would be relatively more exposed to adverse selection during economic upturns and to moral hazard during downturns. Applied research has found that universal banks face lower risk than commercial banks during both upturns and downturns. In addition, the risk differential between universal and commercial banks gets wider and more significant during downturns.

4) Finance and Development

Given the characteristics of Islamic finance mentioned above, particularly the fact that Islamic banks operate according to the rules of universal rather than commercial banking, we can ask which system gives better support to economic performance.


entrepreneurial efforts to develop the economy. Empirical findings seem to confirm such intuition.

Calomiris (2000), through his study of pre-World-War I Germany, has found that universal banking served to reduce the cost of financing industrialization in Germany relative to its corresponding level in other countries where commercial banking is prevalent. He also found that the financial sector reached a higher level of allocative efficiency in the former than in the latter country. We can therefore rest assured that banks operating as universal banks give better support to development efforts.

It is widely accepted that economic development requires mobilization of vast financial resources both internally and externally. Any financial resources left hoarded would imply unrealized potential for economic development. As Islamic teachings emphatically prohibit trading present for future money at a rate of interest, many Muslims hold their funds outside the banking and financial sector, thereby missing an opportunity to apply those funds to the development process. Islamic finance opens the door to the effective use of much needed financial resources within many Islamic countries that would be otherwise kept idle. In addition, it provides Muslims with a way through which they can participate in the development process without exceeding their religious beliefs. Muslim minorities in other countries, whose banking systems do not provide Islamic financial products, suffer from cultural exclusion. Some of those Muslims may have to keep their savings outside the financial system thereby contributing to idle financial resources in their countries.

5) Integrity

Conventional finance can be likened to a spectator’s game where few skilled players stay in the playground and a big crowd is watching from outside. Islamic
finance, meanwhile, is similar to participatory sports, where every one is playing and no one is concerned with mere watching. In addition, there is a moral side to Islamic finance that seems to be in the back of mind of everyone.

Risk is known to be one of the most important ingredients of making investment. Those who finance investment share a good part of the risk involved with those who carry out actual investment activities. Conventional finance leaves risk to be borne by specialists. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves apart from certain kinds of risk, like those attached to production, marketing and distribution, and limit their exposure to risk related to collateral only.

Islamic finance allows savers who deposit their funds to share with banks the risks associated with choosing the right investment and how successful it would be. Banks and financial institutions advancing funds share risk with those receiving finance, including producers, traders, and the like. Islamic finance with proper corporate governance allows depositors some influence on banks investment decisions and allows banks and financial institutions a share in the decision making process, by sitting on the boards of directors of firms receiving funds.

We can therefore notice that risk as well as decision-making is spread over a much larger number and wider variety of concerned people. Risk sharing is balanced by sharing in decision-making. This allows for wider involvement in economic activities, so that people will eventually feel they are partners rather than spectators.

The benefit of wider involvement goes beyond the mere feeling of involvement. It adds to the stability of banks. Holders of investment deposits with banks share in both the profits and losses. When a bank faced the unlikely event of an overall loss over the placement of its investment pool, its depositors shoulder their proportional share of the loss. Individual banks as well as the banking system as a whole would therefore be less likely to break down.
6) Equity

Islamic financial institutions must be viewed as basically private profit-seeking business enterprises that operate according to the market mechanism. By themselves, they cannot reduce, let alone, eradicate poverty. However, if given the right tools, they can contribute to the efforts taken by the whole society in that regard.

Islam prescribes a tax-subsidy approach to reducing poverty. A levy called Zakah is paid out by the wealthy (those whose wealth exceeds a certain minimum level) in proportion to their property.

Zakah proceeds are to be earmarked for several uses including income and wealth maintenance for the poor. Income maintenance is provided within narrow limits to those incapable of work and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor productive assets, which they can use to produce goods and services and sell them for profit. This method of poverty reduction can be closely intertwined with that of economic development, as redistribution is mostly directed towards making the poor more productive, which in turn contributes to economic development.

Income maintenance would involve regular (monthly) payments to the needy. Wealth maintenance, meanwhile, involves transferring to the poor a combination of productive resources, which would be capable of generating sufficient income to maintain at least one household.

Zakah collection would be expected to be carried out mostly by nongovernmental and sometimes by governmental organizations. Islamic banks can help by acting as custodians and in the disbursement of the proceeds. In addition, non-banking financial institutions can also take part in collecting Zakah, using Islamic banks as depositories, and invest the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they would also add a
proportion of Zakah due on their shareholders equity. They can even accept direct payments of Zakah and other donations on behalf of philanthropic institutions.

As to income maintenance, Islamic banks and financial institutions can credit the accounts of the prescribed poor with monthly payments. Wealth maintenance can be implemented through the establishment of micro enterprises that would be owned and operated by the poor. While, the titles to such enterprises are transferred to the poor, certain measures must be taken to insure that the new businesses would not be immaturesly liquidated to finance consumption outlays for their owners. The experience of Islamic banking and financial institutions in project financing should come in handy in eradicating poverty and increasing equity through proper use of Zakah proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collateral and guarantees. Thus those already rich would have most access to finance. In contrast, Islamic finance providing funds on equity or profit-sharing basis would be more concerned about profitability and rate of return and less concerned about collateral as the primary consideration. Those who are not wealthy, but have worthy investment projects, would have more access to finance.

7) Sustainability

Conventional debt has certain characteristics that could place debtors in difficulties if circumstances do not allow them to repay in time. Interest is usually calculated on the outstanding balance of debt, usually compounded annually and sometimes at shorter intervals. Delinquent debtors are often subjected to penalty rates of interest, which are higher than regular rates. It is not uncommon to find borrowers who end up paying debt service that is many folds the original principal they

Understandably, there may be other expenditures items which would be financed from zakah proceeds. That is why only a proportion of them would be handed to collectors. Such proportion can be determined by society and could change from year to year.
to debtor countries. Despite continuous efforts, the debt problems faced by developing countries seem to be ever-present.

We can therefore conclude that interest based financing lacks a great deal of sustainability. Creditors have to stop every few years to give debtors relief in terms of rescheduling and forgiveness. Sometimes this also includes floating low quality debt at lower market value and swapping it with equity. The system has demonstrated unsustainability several times.

Unconventional debt created through Islamic finance has characteristics with which debt crises are less likely to rise. Particularly, the total value of debt, which includes the spot value of commodities purchased on credit as well as an implicit mark-up, is set from the very beginning. The total value of debt can be repaid in installments, without increase in its total value, as there is no compounded interest to pay on outstanding balance.

When debtors face unavoidable circumstances that would make them temporarily insolvent, they are often granted grace periods to help them bring their finances back to order. No penalty fees can be levied in this case. In other words, debt rescheduling, when justifiable, would be granted at no extra cost to borrowers. Therefore, we can conclude that Islamic finance is sustainable and less liable in itself to cause undue hardship to debtors.

Quite often, conventional debt cannot be repaid because it was not used for its prescribed purpose. Under the rules of conventional finance, creditors assume that the use of the loans they extend would strengthen the ability of debtors to meet their future obligations. However, conventional loans are usually offered without ways or
mechanisms to assure their use for certain purposes. In contrast, Islamic debt is created through the finance of acquiring goods and services on credit. In other words, the loan is used from the very beginning for its prescribed purpose. Default resulting from improper use of borrowed funds would therefore be most unlikely.

As Islamic finance provided to finance investment is asset-based, i.e., it is used to acquire real assets; it is much less likely to lead to debt crises. Such type of asset-based finance, directly contributes to the ability of the economy to meet its internal and external financial obligations. This is certainly a welcome effect.

2.4 Some Basics related to Sale: Definition; Types; Ethics; Basic Rules

Since Murabahah is originally a sale contract, it is, therefore, imperative to discuss some basics concerning sale.

2.4.1 Definition of Sale

A sale (bay) is an exchange of one item for another. The Arabic term “bay” refers both to the activities of buying and selling.

- For the Hanafis, it means the exchange of an owned commodity (maal) for another in a specified manner; or the exchange of an owned commodity for another in a beneficial and special manner. This excludes unbenevolent exchanges (e.g. the exchange of one coin for an identical one), or the exchange of bads (i.e. items of no worth, e.g. dead animals, or dust)

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74 In cases where a loan is earmarked for the purchase of commodities, a conventional bank would find it cheaper to enforce earmarking through a sale-finance contract.


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Al-Nawawi defined sale as “the exchange of an owned commodity for another with the exchange of ownership”\(^{77}\) Ibn-e Qudamah defined it similarly, emphasizing both the exchange of ownership, and taking possession by the new owner.\(^{78}\)

Professor Al-Zarqa, a Shariah expert defined the sale as follows:

“An owned commodity is any identifiable object with a material value for the people”\(^{79}\). A sale always means a contract consisting of an offer (eijab) and an acceptance (qabul).

Mufti Muhammad Taqi Usmani, another contemporary shariah expert defines it with the following: “the exchange of a thing of value by another thing of value with mutual consent”\(^{80}\).

The general rule in sales is permissibility as it allows each individual to meet his needs in cooperation with others trying to meet their own.

Al-Imam Al-Shafii ruled: “The general rule for all sales is permissibility as long as they are concluded by consenting capable decision makers, except for what the Messenger of Allah (pbuh) has forbidden, or what is sufficiently similar to that which the Messenger of Allah (pbuh) has forbidden; and anything different from those is permissible following the permissibility of sales stated in the book of Allah Almighty (meaning the verses [2:275], [2:282], [4:29], & [2:198]).\(^{81}\)

2.4.2 Types of Sale

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77 Al- Kahateeb al- Shirbini ((Shafi’i), “Hasitay al-Bijirmi ala Sharh al0lqna fi- Hall alfaz Abi Shuja” vol. 2, p. 2 (as cited by Zuhaili, op. cit., p.5)
78 Al- Kahateeb al- Shirbini ((Shafi’i), vol. 3, p. 559 (as cited by Zuhaili, p. 5)
79 See the introduction of his Nazariyya al-Itizam al- Ammah fi al- Fiqh al-Islami (pp.114-118).
80 Usmani, (2005) op. cit., p. 97
81 Zuhaili, (Tr. By El-Gamal), op. cit., p. 7
The classical jurists categorized sales into *Musawamah* (bargaining) and *Amanah* (trust). We begin with quoting what a specialized dictionary entry on the subject of *amanah* sales or sales of trust explain:\(^2\):

“The classical jurists categorized sales, with regard to the way prices are determined, as either sales in which trust, *amanah*, is the key element, or sales in which bargaining, *musawamah*, is the key element. Sales of bargaining are sales in which the seller does not disclose the amount of his investment in whatever he is offering for sale. In such a sale, both parties will agree to transact for a certain price, without the seller’s disclosing to the buyer the price he originally paid for the goods or whatever it is he is offering for sale. Ibn Jazzi, the Maliki jurist, defined *Musawamah* as “the buyer’s negotiating with the seller over a price until they come to an agreement on it, without there ever being mention of how much the seller originally paid for the goods.” In sales of trust, however, the price is specified as being the same as the seller’s investment, or more, or less. Such sales are called sales of trust because the seller is to be taken at his word when he informs the buyer what he paid for the goods for sale.”\(^3\)

Let us see the consideration in sales of this nature. According to Prof. Shacht,

“The main consideration in all such sales is the exclusion of dishonest, unjustified enrichment.”\(^4\)

Let us now turn to another encyclopedia entry for the purpose of furthering our understanding of *amanah*.

The lexical meaning of *amanah* or trust is the opposite of betrayal, and it denotes any legal responsibility charged to a person, including acts of worship or entrusted property. The classical jurists, however, used the word in two ways; as a noun, and as an adjective. The meaning of trust, as a noun, is that which is kept with

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a trustee. As an adjective, the term is used to denote trust sales, like Murabahah, in which the purchaser depends on the conscience of the seller and trusts his/her truthfulness. The Almighty stated in the Qur'an: O you who believe! Do not be false to Allah and His prophet, and do not knowingly be false to the trust that has been reposed in you (8:27). Moreover, the Prophet, upon him be peace, said, “He is not one of us who attempts to cheat us.” This Hadith was related by Muslim, Abu Dawud, and Ibn Majah, from Abu Hurairah.

It is for this reason that if any sort of misrepresentation should be discovered in a muabahah sale, the buyer would have the option to retain the goods he/she purchased, or to return them. Some scholars have added that the buyer will have the further option to subtract from the price whatever extra amount was falsely reported as the original purchase price, and then to subtract a corresponding percentage from the agreed upon margin of profit. Details of the same may be seen in Kashani 5/223, Ibn Qudamah 4/203, Dasuqi 3/164, and Nawawi, Al-muhadhdhab 1/295.85

To explain further, sales of trust are of three kinds: Murabahah (Cost-plus), Tawliyah (investiture) and Wadi‘ah (resale with loss).

Tawliyah (investiture) refers to a sale in which the value of goods as represented by the seller is itself set as their price, with no profit or loss. Alternatively it may be described as resale at the stated original cost.

Wadi‘ah (resale with loss) refers to a sale in which the price is set at less than what the seller says in the value of goods, or resale with a rebate on the stated original cost. While Murabahah is a resale with a stated surcharge that represents the profit. Murabahah is resale with a stated surcharge that represents the profit.86

The above mentioned categories of sales (with respect to the price) may be summed up as follows:

85 Kuwaiti Fiqh Encyclopedia, (Kuwait: Ministry of Endowments and Islamic affairs, 1988) vol. 6, pp. 236-239
86 ibid.
a) Negotiation or bargaining sale (*bay al-musawamah*): It is the sale at the agreed upon price without reference to the original price of the commodity. This is the most common type of sale.

b) Cost-plus sale or Mark up (*bay al-Murabahah*): It is the sale of an object at the price at which it was obtained plus a stated profit margin.

c) At-cost sale or investiture (*bay al-tawliyah*): It is the sale of an object at the same price originally paid for it by the seller. In other words, the object is resold to the buyer for the same price at which the seller obtained it; thus its name suggests that the seller lets the buyer takes his place (*yatawalla*) in the original sale.

d) Below-cost sale, or sale at a loss (*bay al-wadiah*): It is sale of an object at a price below the price for which the seller bought it, i.e. at a given loss. Thus the object is sold with a known discount below the original price.

Abdullah al-Musali says: “Since Murabahah, *tawliyah* and *wadi`ah* are based on trust where buyer has to fully rely on the seller being informed with the original purchase price of the goods, the seller, therefore, must be a person having no breach of trust.”

2.4.3 Ethics of Sales

There are many ethical considerations in sales, including:

a) The avoidance of excessive profits: All religions prohibit excessive taking of advantage of buyers as forms of cheating. However, a moderate degree of such taking of advantage is admissible because otherwise, all trade would cease. However, if one side takes too much advantage of the other, the sale may be deemed void. The Maliki scholars defined excessive disadvantage as a

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profit of one third or more, since that corresponds to the rules of limited will. Therefore, a profit rate of one third or less is considered acceptable.

b) **Truthful and complete disclosure of information:** The seller must give full and truthful information about the product, including its type, origin, and cost. Al-Tirmidhi reported the following Hadith on the authority of Rifa'a: “All merchants are resurrected on the day of judgments as sinners, except for those who feared Allah, treated their customers well, and were truthful”.

c) **Documentation and witnessing of all debts:** It is desirable that all contracts and loans be written, and that witnesses sign for all delayed sales and debts, as Allah has prescribed in His Book.

2.4.4 **Basic Rules of Sale**

Being a sale, Murabahah is governed by all rules and regulations common to sales in Shari'ah. For a proper understanding of Murabahah, it is necessary to have a clear knowledge of the provisions of Islamic law pertaining to sales. Islamic law has laid down enormous rules governing the contract of sale, and the Muslim jurists have written a large number of books, in a number of volumes, to elaborate them in detail. Some important rules may be summarised as follows.

1. **The object of sale must exist at the time of contract:** Only an item that is existent at the time of sale could become the subject of a valid sale transaction. This means that a non-existent thing may not be sold, even on Murabahah. Thus, the sale of non-existent objects such as the produce of the produce may not be effected. Also, the sale of items that may exist and may

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88 Ibn al-Arabi, 'Ahkam Al-Qur'an (vol. 4, p. 1804) as cited by Zuhaili, (Tr. By El-Gamal) op. cit. p. 7
89 Ibid.
90 Al-Qur'an [2:282]
91 This section largely benefit from the book of al-Zuhaili, Usmani, Muhammad Ayyub & others.
92 All these and other rules & conditions related to sale have been treated at length in al-Zuhaili, (Tr. By El-Gamal) op. cit, Chapter 2 'Condition of Sale', p. 13-35. The standpoints & opinions of all four schools of Islamic Jurisprudence have been dealt separately. The said book also dilate upon the issues like condition of conclusion, eligibility of the parties, correspondence of acceptance to the offer, unity of the contract session, condition for the executability of sale, condition for validity, condition for bindingness, Agreement & differences in sale conditions (in relation to all four schools); also refer to Usmani, M.T. p. 97-101.
vanish (e.g. an unborn lamb in the womb or milk in an udder) may not be concluded.

2. **The object of sale must be in the ownership of the seller:** The sold item should necessarily be in the ownership of the seller, and the seller should bear the risk pertaining to it at the time of sale.

3. **The object of sale must be in the physical or constructive possession of the seller:** The seller should have the item in his possession at the time of sale, either by having physical possession or by having constructive possession.\(^{93}\)

The essence of the above mentioned rules pertaining to sale of a commodity may be summed up as follows:

(a) It is existent.

(b) It is owned by the seller.

(c) It is in the physical or constructive possession of the seller.

Here Mufti Muhammad Taqi Usmani remarks adding a note on the basis of the resolution of Vth session of Islami Fiqh Academy\(^ {94}\):

"There is a big difference between an actual sale and a mere promise to sell. The actual sale cannot be effected unless the above three conditions are fulfilled. However one can promise to sell something which is not yet owned or possessed by him. This promise initially creates only a moral obligation on the promisor to fulfill his promise, which is normally not justifiable. Nevertheless, in certain situations, specially where such promise has burdened the promise with some liability, it can be enforceable through the courts of law. In such cases the court may force the promisor to fulfill his promise, i.e. to effect the sale, and if he fails to do so, the court may order him to pay the

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\(^{93}\) In constructive possession, the item is in the control of holder without having physical delivery and he become responsible for all the rights and liabilities pertaining to the item including the risk of its destruction. For Example, A purchases a car from B. B puts it in a garage to which A has free access and he can take the delivery from that place whenever he wishes. Thus the risk of the Car passes on to A and the car is now in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid.

\(^{94}\) Resolution no. 2.3 of the Fifth Session of the Islamic Fiqh Academy, held in Kuwait in the year 1409 AH. See Majallah al-Fiqh al-Islami, vol.5, (2:1599)
promise the actual damages he has incurred due to the default of the promisor.

But the actual sale will have to be effected after the commodity comes into the possession of the seller. This will require separate offer and acceptance, and unless the sale is effected in this manner, the legal consequences of the sale shall not follow.95

4. **The object of sale must be deliverable at the conclusion of sale:** A sale is not valid if the object is impossible to deliver even if owned by the seller. Since that which is not deliverable is comparable to that which does not exist and the sale of the latter is not valid. Thus the sale of birds in the sky, fish in the water and a lost or stolen animal is void. Likewise, the delivery of the sold item to the buyer must be certain and should not depend on a contingency or chance.

5. **The subject of sale must be pure and admissible:** The article should be a legally valid subject of sale in Shari’ah. The object from which it is legal to derive benefit may be sold. Thus, the sale of wine and pork may not be concluded since their use is prohibited.

6. **The subject of sale must be good and a property of value:** The subject of sale should be accepted as a saleable item having a value. Thus, the sale of what may not be used to benefit the people or have no value according to the convention and usage of trade is void.

7. **The object of sale and price must be explicitly known beyond dispute:** The article of sale should be known and identified with certainty, with all necessary details and the price be clearly known and agreed.

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95 Usmani Muhammad Taqi, (2005), "An Introduction to Islamic Finance", Idara-e Isha’at-e- Diniyat (P) Ltd. New Delhi, p.99
Thus, it is not valid to sell an unknown such as one sheep in a herd or to sell with an unknown or unidentified price such as selling an item for its value. Similarly, if the price is uncertain, the sale is void.\footnote{For Example, A says to B, "If you pay within a month, the price is Rs. 50. But if you pay after two months, the price is Rs. 55." B agrees. Here the price is uncertain and the sale is void, unless anyone of the two alternatives is agreed upon by the parties at the time of sale.}

8. **No third party should have rights over the object of sale:** If anyone other than the owner has a legal right to ownership of the merchandise or its usufruct, then the contract is suspended. Hence, the seller cannot sell what he has pawned or rented.

9. **The contract should not have an expiration period:** A sale is defective if it has an expiration period. For instance, if the seller says: I sold you this house for a month for one thousand, the sale is invalid, since a sale must be limited in time and not timed. Ownership of a specific object does not have an expiration date.

10. **The contract should not contain a corrupting condition:** Corrupting conditions are those that lead to an extra benefit to one of the parties of the contract. They are forbidden since such benefit is not legally proscribed, not accepted conventionally, and not appropriate to the nature contracts. Thus, it is not valid to stipulate a condition that the sold animal be pregnant, that the object sold be used by the seller for a period after the sale, or that the buyer lends the seller an amount of money. Except when it has been specified in the law, accepted in custom and convention, required by the contract, or suitable for the transaction.\footnote{Professor Mustafa Al-Zarqa has commented on this topic saying: "Since conventions among people validate conditions in the opinion of some scholars, every condition that is originally defective becomes valid and binding if people make it a convention and use it often. Thus, we can say that the corrupting condition has been juristically eliminated in people’s dealings with the passage of time, and this age’s conditions have all become valid by the very fundamentals of Hanafi inference (ijtihad). (Aqd Al-Bay, p.28)}

In other words, the contract of a sale should be unconditional and not include any condition or clause that would invalidate the transaction in Shari’ah except the
condition which is recognized as a part of the transaction according to the usage of trade.\footnote{For Example, A buys a refrigerator from B, with a condition that B undertakes its free service for 2 years. The condition, being recognized as a part of the transaction, is valid and the sale is lawful.}

Agreements in respect of sales for immediate payment are concluded by offer and acceptance and require that there be a statement as to a determinable quality and quantity. Delivery, for purposes of Shari'ah relates to the removal of obstacles by the seller between the purchaser and the object of the sale, allowing purchaser to take ownership and control of the object.\footnote{Al-Zuhaili - El-Gamal, Volume 1, chapter 3, at pages 66-70. This discussion notes that "if a person purchases wheat in a house, and the seller gives him the key to the house saying: 'I have given you full access and permission to take the object of sale', then the buyer would have received the object of sale" (pages 66-67), and, in footnote 44, noting that giving full access and permission to the buyer is receipt by the buyer even if the buyer did not literally receive the property. This discussion notes a similar position by the Malikis and the Shafi'i is with respect to access and permission, stating that delivery of the keys would constitute access and permission. The Hanbali position, as summarized in the same work, is that possession is determined by the nature of the property.} As a general matter, the purchaser must have full access to or possession of the object with the full permission of the seller under applicable Hanafi, Maliki, and Shafi'i rules, while the Hanbali school is of the position that the taking of possession is determined in accordance with the nature of the property being sold and purchased.

### 2.4.5 Options (khiyar) of sale

The concept of al-khiyar (options) in Islamic law is basically ethical. Al-khiyar (option) generally refers to a specific type of right of either or both parties to the contract to confirm or rescind the contract. Of the various types of options, some are created by mutual consent of the parties to the contract, while others are in the nature of rights existing for either or both parties because of the very operation of the law. The equity of a contract and fulfillment of proper and reasonable expectations of the parties to the contract is of utmost importance. The parties to the contract must be reasonably certain and informed about the countervalues being exchanged, and the implications or outcomes of contracting. The presence of uncertainty or absence of relevant information is termed as gharar which may lead to the contract being invalid. The provision of al-khiyar helps reduce gharar and brings the contract within
Islamically acceptable limits. It helps undo any possibility of wrong committed on a party deliberately or unintentionally. It has also several larger benefits to the society. Through options, the parties to the contract are granted a ‘reassessment’ or ‘cooling off’ period over which they can rationalize their decisions or reverse the same. Thus, the possibilities of conflicts between the parties because of their abrupt, irrational and wrong decisions are minimized.  

Broadly, the classical *fiqh* literature classifies options into the following categories, (though minor variations in the classification method have been reported by some scholars): khiyar al-shart (option by stipulation); khiyar al-tayeen (option of determination or choice); khiyar al-ayb (option for defect); khiyar al-ruyat (option after inspection); and khiyar al-majlis (option of session). Some scholars view khiyar al-tayeen only as a specific form of khiyar al-shart. Some authors discuss about two other options - khiyar al-wasf (option by misrepresentation) and khiyar al-tadlis (option by fraud); while others prefer to discuss these under the broad category of khiyar al-ayb.

To conclude, these different types of options (*khiyarat*) permitted under *shari’ah* may allow cancellation or ratification of the relevant contract and related transaction. These includes among others, options in respect of: (1) misdescription, (2) selection of property, (3) inspection (*al-ru’ya*), (4) defects, and (5) payment (including instalment payments).

Thus, the five options of sales as formalised in classical *fiqh* may be summarized as follows:

- Buyer’s option to rescind: time limited, seller has similar option, but cease before execution of contract;

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101 Al-Zuhaili - El-Gamal, Volume 1, chapter 5, at pages 165-231, which discusses the various types of options recognized by each of the four major school of jurisprudence (seventeen by the Hanafis, two by the Malikis, sixteen by the Sha'is and eight by the Hanbalis). The option must be exercised within a defined time period.
• Option of inspection: the right to see and verify the object of the sale;
• Option of defect: right to return if defective;
• Option of quality: right to specified quality; and
• Option of price: right to fair price within market range.
CHAPTER - III

BACKGROUND

& DEVELOPMENT OF

ISLAMIC FINANCE: AN

OVERVIEW
3.1 Introduction:

Elimination of interest is core of the Islamic financial system. In fact not only Islam but in all the major religions of the world interest has been held as contempt. Besides Islam, Hinduism, Judaism and Christianity all have tried to restrict the practices of interest in some way or the other. In Islam the ruling against interest (riba) is very clear and final.\(^1\) For Christianity and Judaism views on interest can be seen in *Encyclopedia of Religion and Ethics* by James Hastings and for Hindu view on interest please see Bokare’s *Hindu Economics: Eternal Economic Order*.\(^2\)

Several of the ancient philosophers like Plato, Aristotle, the two Catos, Cicero, Seneca and Plutarch, for various reasons, were against the practices of usury. St. Thomas Aquinas was of the view that money was invented chiefly for the purpose of exchange and that its principal use was its consumption and annihilation whereby it is sunk in exchange. Hence it was unlawful to make payment for the use of money lent.\(^3\) Zamir Iqbal, a research officer at the World Bank points out that prohibition of interest is not limited to Islam but is also shared by Judaism and Christianity and the first interest free bank in documented history was established in pre Islamic period i.e. 'Agibi Bank' which was

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1. For Islamic view on interest (riba), please refer to the Quran, chapters: 30:39, 4:161, 3:130-2, and 2:275-81.
established about 700 B.C. in Babylonia and functioned exclusively on an equity basis.4

In the 8th century, Charlemagne made usury a criminal offence. And it was only in the 16th century that interest became prevalent in the Christian world and that too when Popes started financing kings and other business men, even during that period multiple agreements were made among several parties to circumvent the existing laws against interest. It is quite interesting to explore that in spite of prohibition of usury (interest) in all the major religions how the interest or usury has become so indispensable to the present world financial system. It has become so inseparable part of the system that financial system without interest or banking without interest even among the experts could be held as the utopia. In the following paragraphs we shall try to briefly see how receipts for precious metals deposited with goldsmiths developed to bank money and became a source of earning interest.

The present interest-based banking system, which now forms the foundation of the monetary system in each country of the contemporary world, originated from the practices of goldsmiths who established the first modern bank in Europe few centuries ago. These goldsmiths were prepared to offer their services to those who wished to deposit gold coins for safekeeping. Upon taking a deposit of coins, the goldsmith would issue a receipt to the depositor. The receipt would be issued in 'bearer' form, meaning that any individual bearing it could claim back the face value in gold from the goldsmith on demand. As time progressed, the public found that the goldsmiths' receipts would be accepted in payment for goods and services. These receipts had become the earliest form of 'bank money', and were of an entirely different nature to the gold coins produced by the state. As time passed by, it became apparent that there was little need to lend the vault's gold itself as the goldsmiths' own receipts were by now regarded

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as money among the general public, it would suffice for these receipts to be lent out as a proxy for gold coins. This was of great advantage that receipts could be manufactured at almost no cost, whilst gold itself could not be. By lending the receipts instead, the banker could charge interest on the amount lent. Upon repayment, the receipts could be destroyed as easily as they had been manufactured, but the interest charged would remain as revenue. In this way, the shape of interest based banking system was to come in later period and got widespread all corner of the world.

Anyway, emergence of many Muslims states during first half of twentieth century gave impetus to the idea of interest-free banking, which caught swiftness by the 1970s. By 1980s several Muslim countries had started a concerted effort to Islamize whole of their economy and by the end of twentieth century there is hardly a country with substantial Muslim population where Islamic banking is not introduced. At present there are more than 500 Islamic financial institutions in different parts of the world enjoying more than $500 billion of public deposits. Several western and conventional financial institutions have also started offering Islamic banking windows to their customers.

3.2 Spread of Islamic Finance & Banking Industry

Endeavors to establish interest free financial intermediary has been made in different countries at different times. Initially the purpose to establish such institution was avoidance of interest and providing cost free loans to the needy. Initially, we find individual level effort at different parts of the world some in the form of Baitul Maals, Anjuman (Associations), cooperatives, non banking companies, nidhis or even in the form of banks but avoiding the name Islamic for fear of annoying the hostile political establishment in the country.

During Muslim ascendency Baitul Maal were catering to the economic needs of the masses. As Muslim power declined and replaced over by the Europeans who established modern banks, functioning on the basis of interest.
Muslim not happy with these kinds of institutions tried to reestablish their old format i.e. *Baitul Maals* the first such examples can be found during the last decade of the 19th century when a prominent scholar of Hyderabad, India tried to establish an interest free institution called ‘*Anjuman Mowodul Ikhwan*’, this was followed by another such institution called ‘*Anjuman Imdad-e-Bahmi Qardh Bila Sut*’ established in 1923 by the employees of the Department of Land Development (*Mohakm-e-Bandobast-w-Dakhila Huqooq-ul-Aradhi*), within 20 years of its establishment this organization had an asset worth Rs. 100,000 this *Anjuman* (Association) was distributing Rs. 5000-6000 loans per month and enjoyed a membership of 1000 (Muslims and Non-Muslims) with a reserve of Rs. 3000 in 1944.\(^5\) During the period of *Aasafia*, 12 such organizations had established, few of them continued till partition of the country in 1947.

In Pakistan, the first modern banking venture adhering to the tenets of Islamic law was founded in the late 1950s. A few landlords who voluntarily contributed interest free deposits to the fund backed the institution; credit was advanced to poorer landlords for agricultural improvements. No interest was charged for the credit, but there was some administrative fee to cover bank-operating costs. Increasing demands of loan not backed by corresponding deposit soon led to collapse of this pilot project.\(^6\)

Some other experience in this field continued in the form of Cooperatives and Muslim Funds. However, it was only in 1963 when a first modern Islamic bank *The Mit Ghamr Local Saving Bank* could be established in Egypt. Since then Islamic finance services industry has grown tremendously and got mushroomed in the last three decades. A 2005 publication of the International Monetary Fund (IMF) estimated that there were over three hundred Islamic financial institutions worldwide, with an estimated $250 billion in total assets and an annual growth rate

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Thus, Islamic finance has become one of the fastest-growing sectors in the global finance industry. More than 350 Islamic banks and financial institutions are operating in over 50 countries, with total assets that top US$ 400 billion.

To conclude, in recent years there has been significant growth in Islamic financial services. However, Islamic banking, being a recent phenomenon, is still modest in size relative to conventional banking. There is not significant innovation in its services. Neither are there too many kinds of Islamic banks like in conventional i.e. central, commercial, cooperative, regional, developmental etc. Though over the course of the last one and a half decade, a number of various types of Islamic banks such as commercial and investment ones emerged on the scene and many more are under establishment. Let’s divide, for the sake of presenting an overview, these Islamic banks into two chronological orders.

### 3.2.1 Islamic Banking Initiatives Before 1980

Institutions established before 1980 were mainly the result of three kinds of efforts. Individual, community and governmental, these efforts were easily reflected in the character of the institutions.

As mentioned above that the first modern effort to establish interest free institutions can be traced back to 1890s in the southern India. This was mainly a welfare association collecting donations and skins of animals sacrificed during festivals from the public and providing interest free loans to the needy. Another such institution called ‘Anjuman Imdad-e-Bahmi Qardh Bila Sud’ (Interest Free Credit Society) was also established in Hyderabad, (Ducan) India during 1923.

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Patni Co-operative Credit Society, a Surat based institution, which still continues its business was established in 1939. In 1940 'Muslim Fund' Tanda Baoli, Rampur (a district in North India) was established, however, partition of India badly affected the functioning and further establishment of such societies, especially in Indian part, for fairly a long period. Muslim Fund Tanda Baoli was closed down due to partition effect. After a long gap of almost 15 years few social and religious organizations like Jamiat-e-Ulama-e-Hind and Jamat-e-Islami Hind again took the initiative in establishing interest free institutions. The first to be established among them was Muslim Fund Deoband in the year 1961, which is still working. According to the information provided by the Federation of Interest Free Organization (FIFO) there are more than hundred Muslim Funds in the country. Of them, thirty Muslim Funds are the members of FIFO. Toor Baitul Mal, Hyderabad was established in 1966, and Muslim Fund Najibabad (MFN) in 1971, this group is the largest Muslim Fund in the country with more than 40 branches all over India and around 200,000 shareholders. It enjoys deposits of around Rs. 360 million. Muslim Fund Najibabad has also floated a subsidiary called Al-Najib Milli Mutual Benefits Ltd. in the year 1990.

Bait-un-Nasr, Urban Co-Operative Credit Society (BUN) India’s largest and most professional Islamic financial institution was established in the year 1973, BUN is the largest Cooperative Credit Society in any of the Metros of India with more than 155050 shareholders and 20 branches with deposits around Rs.125 million and loan turnover of more than Rs. 365 million in the city of Mumbai

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11 Federation of Interest Free Organization (FIFO) is an apex institution of Muslim Funds in India. FIFO extends credit facility to Muslim Funds at the time of crunch. It also provides training and other facilities to its members.
alone. Restrictions on the society to function outside the geographical boundary of Mumbai and few other restrictions resulted in the formation of Barkat Investment Group in the year 1983.

In other parts of the world as well independence of many Muslim states by the period of 1950 gave momentum to the idea of Islamic banking and so to their establishment. The most glaring example of this period was the establishment of the Mit Ghamr Local Savings Bank in Egypt in 1963 by noted social activist Ahmad-al-Najjar. It is widely accepted as the first modern Islamic bank. It performed all the functions of a modern Islamic bank based on profit sharing. This experiment combined the idea of German savings banks with the principle of rural banking within the general framework of Islamic values. This experiment lasted until 1967 (i.e. for four years) by which time there were nine such banks in the country operating as saving investment institutions.

Another unique experience of this period was the establishment of the ‘Pilgrims’ Management and Fund Board of Malaysia’, popularly known a ‘Tabung Haji’ in the year 1963. The reason for the establishment of this institution was the desire of Malaysian Muslims that money spent on pilgrimage must be clean and untainted with *riba*, since this was not possible by depositing the money with ordinary commercial banks, the Pilgrims’ Saving Corporation was established which latter incorporated into the Pilgrims’ Management and Fund Board in 1969.¹³

Afterward, in 1971 The Nasir Social Bank in Egypt was declared as interest-free commercial bank by a Presidential decree, was the first example of the interest of government in establishment of an interest free institution. The establishment of Dubai Islamic Bank (DIB) in the United Arab Emirates (UAE) as

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¹² Dalvi, M. Abdul Wahab, “Random Thoughts on Some Economic and Legal Challenges to Islamic Banking System” Paper Presented at the Seminar on “Islamic Economics Issues and Challenges” Organized by the Indian Association For Islamic Economics (IAFIE) at New Delhi, India in October 1999.

the world's first full-service Islamic bank by some traders followed it in 1975. It was an outcome of private initiative. In the same year 1975, the Islamic Development Bank (IDB) was established in Jeddah, Saudi Arabia, primarily as an inter-governmental bank with the purpose of providing finance for development projects in member countries. Since then, there is spurt in Islamic banking activities like mushrooming. To conclude, the 1970s witnessed the establishment of a number of Islamic banks esp. in the Middle East, such as Dubai Islamic Bank (1975), Kuwait Finance House (1977), Faisal Islamic Bank of Egypt & Sudan (1977 & 1978 respectively), and the Bahrain Islamic Bank (1979). However, people were still uncertain about the feasibility of Islamic banking and also legitimacy of its practices, a situation that remained through the 1980s.

3.2.2 Islamic Banks (1980-2007)

This period is characterized by the high growth of Islamic banks in terms of volumes as well as in numbers. More than 150 institutions have been established. The turnover and deposits too have increased many folds. Almost every Muslim country including some western and Muslim minority country has seen the establishment of Islamic banks. More and more countries are trying to create jurisdictions and tax changes to accommodate Islamic finance. Many conventional banks too have opened Islamic windows to cater for its customers. Various high level committees have been established to evaluate the performance of these banks. Islamic banking has achieved new heights in this period, various innovations have taken place. They have moved from traditional methods of funding to financial engineering. This is also combined by the various issues, problems and challenges Islamic banks are facing. Now various comparative studies of Islamic banks vis-à-vis conventional banks have exposed Islamic banks
to new competitions. Financial returns of the Islamic banks are also compared now with those of interest-based banks.

Anthony Cook, Senior Vice President of Brown Brothers Harriman the U.S. Private Banks, says: “Twenty years ago, Muslim Investors who wanted to invest under Shariah, had the option of earning zero interest. But since then, a number of organizations have created Islamic investments outlets and, by legitimizing and professionalizing them, they have opened up opportunities for a much longer audience”.

Thus, over the past three decades, Islamic finance has been developed in its modern form, the deposits and businesses of Islamic banks and other financial institutions have multiplied many folds.

For the sake of showing a brief comprehensive overview of contemporary Islamic finance industry position, let us take some excerpts from the two latest reports on Islamic Finance (2008) of Banker and Islamic Financial Services London (IFSL). Let us first begin by quoting Banker survey made on IFSI.

In addition to 292 banks, both fully Islamic and those offering Islamic windows or selling Islamic products, there are 115 Islamic investment banks and finance companies and 118 insurance companies, adding up to a total of 525 institutions from which the Top 500 was drawn. Analyzing the $500.5bn global market, the six seats of the Gulf Cooperation Council (GCC- Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) provide the largest chunk of the total but the non-GCC Middle East and North Africa (MENA) states are not far behind. While the overall total grew by 29.7% to $ 500.5bn in the listing, the GCC institutions expanded the most by 39.4 % to $178.1bn and the non-GCC MENA institutions grew by 29.9% to reach $176.8bn.

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14 Bashir, Darrat & Sulaiman, 1993
15 Wilson, Rodney, 'Islamic Financial Market', Routledge, 1990
Asia, led by Malaysia, Brunei and Pakistan, is the third largest region in the world for sharia-compliant assets, growing by 20.9% to $119.3bn. The grouping of Institutions from Australia, Europe and North America accounts for $21.5bn with sub-Saharan African institutions accounting for $4.7bn in assets. Looking at the overall global total, the MENA region accounts for a huge 70.9% of the $500.5bn total, split almost evenly between the GCC states with 35.6% and the non-GCC MENA states with 35.3%. Asia comes in third with 22.7% of the market.17

Of the 525 institutions assessed for the Top 500, 115 fell into the category of investment bank, investment company or asset manager. Among the top 25 below, 20 come from the six Gulf Cooperation Council (GCC) states, showing the strength of the Gulf institutions in this area. But definitions can again be a problem and some would argue whether the leading player listed, Saudi Arabia’s Al Rajhi Bank, is more a commercial bank than an investment bank. Also at this stage, we do not have the specific figures to reflect HSBC Amanah’s sizeable investment banking role. The Top 25 shows that Bahrain has the largest number of leading Islamic Investment banks, with nine, and Kuwait has six 100% sharia-compliant investment houses. While most of the Top 25 are well-established outfits, they remain relatively small, as their figure suggest, compared with many foreign owned or conventional investment houses operating in the region.

17 C D ‘Jay’ Jung, ‘TOP 500 Islamic Institutions’. The Banker, 5 Nov. 2007
### Table-1

**TOP 25 ISLAMIC INSTITUTIONS BY ROA**

<table>
<thead>
<tr>
<th>Ranking</th>
<th>RoA</th>
<th>Top 500 Institution</th>
<th>Country</th>
<th>assets (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>215</td>
<td>El Nilein Insurance Co.</td>
<td>Sudan</td>
<td>37.27%</td>
</tr>
<tr>
<td>2</td>
<td>75</td>
<td>Tamweel</td>
<td>UAE</td>
<td>35.10%</td>
</tr>
<tr>
<td>3</td>
<td>117</td>
<td>International Leasing and Investment Co.</td>
<td>Kuwait</td>
<td>33.51%</td>
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<tr>
<td>4</td>
<td>185</td>
<td>Karafarin Insurance Co</td>
<td>Iran</td>
<td>21.03%</td>
</tr>
<tr>
<td>5</td>
<td>190</td>
<td>Islamic Insurance Company</td>
<td>Sudan</td>
<td>20.91%</td>
</tr>
<tr>
<td>6</td>
<td>97</td>
<td>First Investment Company</td>
<td>Kuwait</td>
<td>20.58%</td>
</tr>
<tr>
<td>7</td>
<td>198</td>
<td>The United Insurance Co. (Sudan)</td>
<td>Sudan</td>
<td>18.72%</td>
</tr>
<tr>
<td>8</td>
<td>169</td>
<td>First Takaful Insurance Co</td>
<td>Kuwait</td>
<td>16.90%</td>
</tr>
<tr>
<td>9</td>
<td>131</td>
<td>Al Madina for Finance and Investment Co.</td>
<td>Kuwait</td>
<td>16.52%</td>
</tr>
<tr>
<td>10</td>
<td>130</td>
<td>Al Safat Investment Company</td>
<td>Kuwait</td>
<td>15.49%</td>
</tr>
<tr>
<td>11</td>
<td>112</td>
<td>Unicorn Investment Bank BSC</td>
<td>Bahrain</td>
<td>13.62%</td>
</tr>
<tr>
<td>12</td>
<td>65</td>
<td>AREF Investment Group</td>
<td>Kuwait</td>
<td>13.24%</td>
</tr>
<tr>
<td>13</td>
<td>27</td>
<td>Bank Al Jazira</td>
<td>Saudi Arabia</td>
<td>13.21%</td>
</tr>
<tr>
<td>14</td>
<td>115</td>
<td>Bank Perusahaan Kecil &amp; Sederhana</td>
<td>Malaysia</td>
<td>13.19%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Malaysia Bd (SME Bank)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>148</td>
<td>Sheikan Insurance &amp; Reinsurance Co.</td>
<td>Sudan</td>
<td>13.06%</td>
</tr>
<tr>
<td>16</td>
<td>63</td>
<td>National Investment Trust, Karachi</td>
<td>Pakistan</td>
<td>12.78%</td>
</tr>
<tr>
<td>17</td>
<td>183</td>
<td>Arabia ACE Insurance Company</td>
<td>Bahrain</td>
<td>12.59%</td>
</tr>
<tr>
<td>18</td>
<td>210</td>
<td>Arabia ACE Insurance Company</td>
<td>Saudi Arabia</td>
<td>12.59%</td>
</tr>
<tr>
<td>19</td>
<td>222</td>
<td>KUWAIT FINANCIAL CENTRE (Markaz)</td>
<td>Kuwait</td>
<td>12.01%</td>
</tr>
<tr>
<td>20</td>
<td>222</td>
<td>Al Ain Ahlia Insurance Co</td>
<td>UAE</td>
<td>11.93%</td>
</tr>
<tr>
<td>21</td>
<td>119</td>
<td>International Investment Group</td>
<td>Kuwait</td>
<td>11.53%</td>
</tr>
<tr>
<td>22</td>
<td>34</td>
<td>Ithmaar Bank BSC</td>
<td>Bahrain</td>
<td>10.82%</td>
</tr>
<tr>
<td>23</td>
<td>114</td>
<td>Sokouk Holding Company</td>
<td>Kuwait</td>
<td>10.60%</td>
</tr>
<tr>
<td>24</td>
<td>211</td>
<td>Red Sea Insurance Company</td>
<td>Sudan</td>
<td>9.93%</td>
</tr>
<tr>
<td>25</td>
<td>121</td>
<td>Khaleeji Commercial Bank</td>
<td>Bahrain</td>
<td>9.56%</td>
</tr>
</tbody>
</table>

**Source:** *The Banker*

<table>
<thead>
<tr>
<th>Rank</th>
<th>Pre-tax profits</th>
<th>Country</th>
<th>Top 500 Institution</th>
<th>Country</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>13,920.70</td>
<td>France</td>
<td>BNP Paribas</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>10,700.63</td>
<td>Germany</td>
<td>Deutsche Bank AG</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>10,638.73</td>
<td>France</td>
<td>Société Générale</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>2,599.87</td>
<td>Switzerland</td>
<td>Credit Suisse</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>1,949.77</td>
<td>Saudi Arabia</td>
<td>Al Rajhi Bank</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>1,675.29</td>
<td>Saudi Arabia</td>
<td>National Commercial Bank, Jeddah</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>1,638.02</td>
<td>South Africa</td>
<td>ABSA Group</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>1,539.20</td>
<td>Singapore</td>
<td>OCBC Bank</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>1,391.29</td>
<td>Saudi Arabia</td>
<td>Samba Financial Group</td>
<td></td>
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<tr>
<td>10</td>
<td>973.30</td>
<td>Malaysia</td>
<td>Maybank</td>
<td></td>
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<tr>
<td>11</td>
<td>966.36</td>
<td>UK</td>
<td>Lloyds TSB</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>877.80</td>
<td>Kuwait</td>
<td>National Bank of Kuwait</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>811.82</td>
<td>Saudi Arabia</td>
<td>Saudi British Bank</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>802.92</td>
<td>Saudi Arabia</td>
<td>Banque Saudi Fransi</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>776.65</td>
<td>Saudi Arabia</td>
<td>Riyadh Bank</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>690.96</td>
<td>Malaysia</td>
<td>Public Bank Berhad</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>668.82</td>
<td>Saudi Arabia</td>
<td>Arab National Bank</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>668.29</td>
<td>Kuwait</td>
<td>Kuwait Finance House, Safat</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>654.85</td>
<td>Indonesia</td>
<td>PT Bank Rakvat Indonesia</td>
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</tr>
<tr>
<td>20</td>
<td>587.32</td>
<td>UAE</td>
<td>National Bank of Abu Dhabi</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>585.58</td>
<td>Iran</td>
<td>Bank Melli Iran, Tehran</td>
<td></td>
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<tr>
<td>22</td>
<td>584.67</td>
<td>UAE</td>
<td>Abu Dhabi Commerical Bank</td>
<td></td>
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<tr>
<td>23</td>
<td>550.70</td>
<td>Qatar</td>
<td>Qatar National Bank (Al Watani)</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>535.72</td>
<td>Saudi Arabia</td>
<td>Saudi Investment Bank</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>527.0917</td>
<td>Saudi Arabia</td>
<td>Bank Al Jazira</td>
<td></td>
</tr>
</tbody>
</table>

Source: The Banker
## Table-3

### TOP 25 ISLAMIC INVESTMENT BANKS

<table>
<thead>
<tr>
<th>RoA</th>
<th>Institution</th>
<th>Country</th>
<th>Compliant assets $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Al Rajhi Bank</td>
<td>Saudi Arabia</td>
<td>28,093.12</td>
</tr>
<tr>
<td>2</td>
<td>Qatar Islamic Bank</td>
<td>Qatar</td>
<td>4,090.25</td>
</tr>
<tr>
<td>3</td>
<td>Investment Dar</td>
<td>Kuwait</td>
<td>3,978.00</td>
</tr>
<tr>
<td>4</td>
<td>ABC Islamic Bank</td>
<td>Bahrain</td>
<td>3,484.00</td>
</tr>
<tr>
<td>5</td>
<td>Ithmaar Bank BSC</td>
<td>Bahrain</td>
<td>3,179.94</td>
</tr>
<tr>
<td>6</td>
<td>Arcapita Bank</td>
<td>Bahrain</td>
<td>2,707.71</td>
</tr>
<tr>
<td>7</td>
<td>Qatar International Islamic Bank, Doha</td>
<td>Qatar</td>
<td>2,307.12</td>
</tr>
<tr>
<td>8</td>
<td>Shamil Bank</td>
<td>Bahrain</td>
<td>1,693.26</td>
</tr>
<tr>
<td>9</td>
<td>Aayan Leasing and Investment Co.</td>
<td>Kuwait</td>
<td>1,642.18</td>
</tr>
<tr>
<td>10</td>
<td>Gulf Finance House BSC</td>
<td>Bahrain</td>
<td>1,631.02</td>
</tr>
<tr>
<td>11</td>
<td>National Investment Trust, Karachi</td>
<td>Pakistan</td>
<td>1,248.40</td>
</tr>
<tr>
<td>12</td>
<td>Masraf Al Rayan</td>
<td>Qatar</td>
<td>1,188.00</td>
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<tr>
<td>13</td>
<td>AREF Investment Group</td>
<td>Kuwait</td>
<td>1,179.60</td>
</tr>
<tr>
<td>14</td>
<td>Qatar Real Estate Investment Co.</td>
<td>Qatar</td>
<td>1,043.10</td>
</tr>
<tr>
<td>15</td>
<td>Kuwait Finance House (Malaysia) Bd</td>
<td>Malaysia</td>
<td>855.49</td>
</tr>
<tr>
<td>16</td>
<td>Banque Al Baraka D'Algerie</td>
<td>Algeria</td>
<td>564.10</td>
</tr>
<tr>
<td>17</td>
<td>Al Baraka Islamic Investment Bank</td>
<td>Bahrain</td>
<td>559.66</td>
</tr>
<tr>
<td>18</td>
<td>The International Investor, Safat</td>
<td>Kuwait</td>
<td>549.86</td>
</tr>
<tr>
<td>19</td>
<td>Khaleej Finance &amp; Investment Co.</td>
<td>Bahrain</td>
<td>519.67</td>
</tr>
<tr>
<td>20</td>
<td>Al Salam Bank</td>
<td>Bahrain</td>
<td>500.15</td>
</tr>
<tr>
<td>21</td>
<td>First Investment Company</td>
<td>Kuwait</td>
<td>482.40</td>
</tr>
<tr>
<td>22</td>
<td>European Islamic Investment Bank</td>
<td>UK</td>
<td>463.82</td>
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<tr>
<td>23</td>
<td>Al Amin Bank</td>
<td>Bahrain</td>
<td>430.94</td>
</tr>
<tr>
<td>24</td>
<td>Gulf Investment House</td>
<td>Kuwait</td>
<td>388.27</td>
</tr>
<tr>
<td>25</td>
<td>Amlinvestment Group Bd</td>
<td>Malaysia</td>
<td>353.93</td>
</tr>
</tbody>
</table>

Source: The Banker
## Table-4

<table>
<thead>
<tr>
<th>Ranking by RoA</th>
<th>Top 500</th>
<th>Institution</th>
<th>Country</th>
<th>Sharia compliant assets $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3</td>
<td>Takaful IBB Berhad</td>
<td>Brunei</td>
<td>31,535.19</td>
</tr>
<tr>
<td>2</td>
<td>60</td>
<td>Iran Insurance Company</td>
<td>Iran</td>
<td>1,515.98</td>
</tr>
<tr>
<td>3</td>
<td>79</td>
<td>Syarikat Takaful Malaysia Bd</td>
<td>Malaysia</td>
<td>825.82</td>
</tr>
<tr>
<td>4</td>
<td>82</td>
<td>The Co. for Co-operative Insurance</td>
<td>Saudi Arabia</td>
<td>733.27</td>
</tr>
<tr>
<td>5</td>
<td>105</td>
<td>Islamic Arab Ins. Company-Salama</td>
<td>UAE</td>
<td>375.39</td>
</tr>
<tr>
<td>6</td>
<td>118</td>
<td>B.E.S.T. Retakaful</td>
<td>Tunisia</td>
<td>279.88</td>
</tr>
<tr>
<td>7</td>
<td>129</td>
<td>Solidarity Insurance Company</td>
<td>Bahrain</td>
<td>227.13</td>
</tr>
<tr>
<td>8</td>
<td>140</td>
<td>Alborz Insurance Company</td>
<td>Iran</td>
<td>189.82</td>
</tr>
<tr>
<td>9</td>
<td>141</td>
<td>Al Khaleej Insurance &amp; Reinsurance Co.</td>
<td>Qatar</td>
<td>189.43</td>
</tr>
<tr>
<td>10</td>
<td>145</td>
<td>Qatar Islamic Insurance Company</td>
<td>Qatar</td>
<td>125.93</td>
</tr>
<tr>
<td>11</td>
<td>148</td>
<td>Sheikan Ins. &amp; Reinsurance Co.</td>
<td>Sudan</td>
<td>105.689</td>
</tr>
<tr>
<td>12</td>
<td>149</td>
<td>Takaful Ikhlas Sdn Bhd</td>
<td>Malaysia</td>
<td>99.62</td>
</tr>
<tr>
<td>13</td>
<td>159</td>
<td>Saudi Arabian Insurance Co.</td>
<td>Saudi Arabia</td>
<td>67.80</td>
</tr>
<tr>
<td>14</td>
<td>161</td>
<td>Abu Dhabi National Takaful Co</td>
<td>UAE</td>
<td>65.12</td>
</tr>
<tr>
<td>15</td>
<td>163</td>
<td>Gulf Takaful Insurance Company</td>
<td>Kuwait</td>
<td>61.00</td>
</tr>
<tr>
<td>16</td>
<td>169</td>
<td>First Takaful Insurance Company</td>
<td>Kuwait</td>
<td>54.78</td>
</tr>
<tr>
<td>17</td>
<td>173</td>
<td>Takaful International Company</td>
<td>Bahrain</td>
<td>38.50</td>
</tr>
<tr>
<td>18</td>
<td>179</td>
<td>Asean Retakaful International</td>
<td>Malaysia</td>
<td>26.09</td>
</tr>
<tr>
<td>19</td>
<td>180</td>
<td>Farest Islami Life Insurance</td>
<td>Bangladesh</td>
<td>25.78</td>
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<tr>
<td>20</td>
<td>183</td>
<td>Arabia ACE Insurance Co.</td>
<td>Bahrain</td>
<td>21.65</td>
</tr>
<tr>
<td>21</td>
<td>185</td>
<td>Karafarin Insurance Company</td>
<td>Iran</td>
<td>20.94</td>
</tr>
<tr>
<td>22</td>
<td>188</td>
<td>PT Asuransi Syariah Mubarakah</td>
<td>Indonesia</td>
<td>14.86</td>
</tr>
<tr>
<td>23</td>
<td>190</td>
<td>Islamic Insurance Company</td>
<td>Sudan</td>
<td>13.21</td>
</tr>
<tr>
<td>24</td>
<td>191</td>
<td>Allied Cooperative Insurance Group</td>
<td>Saudi Arabia</td>
<td>11.95</td>
</tr>
<tr>
<td>25</td>
<td>193</td>
<td>SOSAR AL AMANE</td>
<td>Senegal</td>
<td>10.51</td>
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</table>

Source: The Banker
<table>
<thead>
<tr>
<th>Number</th>
<th>Institution Name</th>
<th>Country</th>
<th>Initial Date</th>
<th>Assets (US$)</th>
</tr>
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<tr>
<td>1</td>
<td>Al-Bader Islamic Bank</td>
<td>Kuwait</td>
<td>2006</td>
<td>n/a</td>
</tr>
<tr>
<td>2</td>
<td>The International Islamic Union Bank</td>
<td>Yemen</td>
<td>2006</td>
<td>n/a</td>
</tr>
<tr>
<td>3</td>
<td>Taseer Bank</td>
<td>France</td>
<td>2006</td>
<td>n/a</td>
</tr>
<tr>
<td>4</td>
<td>Bear Stearns &amp; Co. Arab Asset Management</td>
<td>Saudi Arabia</td>
<td>2006</td>
<td>n/a</td>
</tr>
<tr>
<td>5</td>
<td>British Islamic Insurance Holdings</td>
<td>UK</td>
<td>2006</td>
<td>n/a</td>
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<tr>
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<td>Saudi WBC Co-operative Insurance Co</td>
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<td>Oct-06</td>
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<td>Gulf African Bank</td>
<td>Kenya</td>
<td>Sep-06</td>
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<td>8</td>
<td>Bank of London and the Middle East</td>
<td>UK</td>
<td>Jul-06</td>
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<td>9</td>
<td>Al-Amin for Real Est., Dev't &amp; Fin. Co.</td>
<td>Saudi Arabia</td>
<td>Jun-06</td>
<td>n/a</td>
</tr>
<tr>
<td>10</td>
<td>Global Banking Corporation</td>
<td>Bahrain</td>
<td>Jun-06</td>
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</tr>
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<td>11</td>
<td>Amiaa Finance and Real Est. Invest.</td>
<td>Egypt</td>
<td>Jun-06</td>
<td>n/a</td>
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<tr>
<td>12</td>
<td>The First Community Bank Ltd</td>
<td>Kenya</td>
<td>Jun-06</td>
<td>n/a</td>
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<td>Damas Investments</td>
<td>UAE</td>
<td>08-May-07</td>
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<td>Singapore</td>
<td>May-07</td>
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<td>Kokai Mahindot Asset Management Co.</td>
<td>India</td>
<td>Mar-07</td>
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<tr>
<td>16</td>
<td>Sabeeb</td>
<td>Kuwait</td>
<td>Apr-07</td>
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<td>17</td>
<td>Kuwait Financial Centre (Markaz)</td>
<td>Kuwait</td>
<td>Mar-07</td>
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<td>18</td>
<td>Noor Takaful Insurance</td>
<td>Syria</td>
<td>Mar-07</td>
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<tr>
<td>19</td>
<td>Alkantak Takaful (Bahraini) BSC</td>
<td>Bahrain</td>
<td>Mar-07</td>
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<td>Mar-07</td>
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<td>Capital Management House</td>
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<td>6-Feb-07</td>
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<td>22</td>
<td>Assil Finance</td>
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<td>Emirates Global Islamic Bank Ltd</td>
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<td>Asian Finance Bank (Bahrain)</td>
<td>Malaysia</td>
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<td>Jan-07</td>
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<td>Al-Hilal Bank (the Crescent Bank)</td>
<td>UAE</td>
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<td>Dubai Bank (Masraf Dubai)</td>
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<td>Syrian Qatar Takaful Insurance</td>
<td>Syria</td>
<td>2007</td>
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<td>First Dawood Islamic Bank Co</td>
<td>Pakistan</td>
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<td>ABN AMRO Pakistan</td>
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<td>Noor Islamic Bank</td>
<td>UAE</td>
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<td>Mawasir Finance</td>
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<td>UBL Limited Ameen</td>
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<td>Dec-06</td>
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<td>Salama Hotelic Housing Solutions BSC</td>
<td>Bahrain</td>
<td>Dec-06</td>
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<td>Al Ahsa Takaful Company</td>
<td>Saudi Arabia</td>
<td>Dec-06</td>
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<td>Al Ahli Takaful Insurance Co for Co-op.</td>
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<td>Nov-06</td>
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<td>Isqat Capital</td>
<td>UAE</td>
<td>Nov-06</td>
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<td>Masraf Al Rayan</td>
<td>Qatar</td>
<td>Oct-06</td>
<td>1,188.00</td>
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<td>Al Sarherbini Co. For Islamic Fin. Inv.</td>
<td>Jordan</td>
<td>Oct-06</td>
<td>n/a</td>
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</table>

| Source: The Banker | 88 |
Islamic Financial Services London (IFSL) UK has presented a comprehensive report country & sector wise covering Islamic funds, Sukuk issuance, Takaful business etc. According to its report “Islamic Finance 2008”18, “The global market for Islamic financial services, as measured by Sharia compliant assets, is estimated to have reached $531bn at end-2006, having grown by over 10% a year from about $150bn in the mid-1990s.

Islamic commercial banks accounted for 75% of the assets $397bn, and investment banks 13%, $66bn. The balance is made up by Sukuk issues $44bn; assets of equity funds and other off-balance sheet investments $14bn and assets of Takaful providers $10bn. Standard & Poor’s has estimated that the potential market for Islamic finance could be $4 trillion, over seven times its current size.

Assets that can be allocated to individual countries from The Banker’s survey of 500 organisations reveal that the leading countries for Sharia compliant assets are Iran with $154bn, Saudi Arabia along with other Gulf states, and Malaysia. The UK, in 9th place, is the leading Western country with $10bn of reported assets, largely based on HSBC Amanah.

The market for Islamic financial services has developed in a number of keyways, with respect to emerging centres of expertise; a broadening geographical spread of customers; an increasing number of providers; and the growing range of Sharia compliant financial services being marketed.”

Emerging centres of expertise: Bahrain, Dubai/UAE and Kuala Lumpur have strong historical positions and future ambitions as centres for Islamic financial services. Riyadh, Qatar, and Singapore also have aspirations to become centres for Islamic finance. London is positioning itself as the gateway to Islamic finance in Western Europe.

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Broadening geographical customer base for Islamic services: The market is currently most developed in Malaysia, Iran and the majority of countries that form the Gulf Co-operation Council (GCC). However, Islamic finance is moving beyond its historic boundaries in these countries into new territories both within and outside the Arab world. Key future markets include:

- Other Arab countries such as Egypt, Turkey, Lebanon and Syria.
- Other Asian countries such as Indonesia, which has the largest indigenous Muslim population in the world, and China.
- Western countries in Europe and North America. Countries such as the US, France, Germany and the UK each have indigenous Muslim populations of between one and five million. Moreover, the customer base in Western countries is not necessarily restricted to Moslems: other customers may be attracted by the ethical and environmental basis of Islamic finance.

Historic providers of Islamic finance are facing competition from newly established providers and from conversion of conventional institutions.

Sharia compliant financial services: Banking and Sukuk - the issue of Islamic notes - represent the forms of Islamic finance that are most well established, although Takaful (insurance) and equity funds are evolving. Products that may be the subject of innovation include private equity, hedge funds and derivatives.

Banking: Existing Islamic banks have started to build on their natural competitive advantages including customer loyalty, sensitivity to religious practices and stable base of deposits. Conventional banks also have moved to open Islamic ‘windows’ through setting up branches, creating Sharia compliant subsidiaries or converting to become fully Sharia compliant banks. In a survey by the Banker, balance sheet assets of Sharia compliant bank assets totalled $463bn in 2006, of which $397bn were in commercial banks and $66bn in investment
banks. It is estimated that about 55% of the total bank assets were in Islamic banks and 45% in Islamic windows of conventional banks.

Malaysia and Pakistan have over 20 banks supplying Islamic financial services; Kuwait and Bahrain each have 17; and Iran, Saudi Arabia and Bangladesh each have around 10.\(^{19}\) Three UK banks reported to the Banker’s survey, although there are estimated to be 23 in total. Market share of Islamic banks in Malaysia and the Gulf Cooperation Council (GCC) has been rising. In Malaysia between 2003 and 2006 the share of Islamic banks increased from 9% to 12% while in the GCC it rose from 13% to 17%. Within the GCC, Kuwait and Saudi Arabia are the countries in which Islamic banks’ market share is highest and has grown the fastest.\(^{19}\)

![Fig. 1: Trends in the Size of Islamic Finance Industry from 1983 to 2005 (In Billions of US Dollars)](image)

### 3.2.3 Islamization of Financial System

Measures to Islamize the financial system have been introduced in several countries like Saudi Arabia, Kuwait, Sudan, the U.A.E., Bahrain, Jordan, Malaysia

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\(^{19}\) For details, see the figures (charts and tables) at [http://www.ifsl.org.uk/upload/Islamic_Finance_2008(1).pdf](http://www.ifsl.org.uk/upload/Islamic_Finance_2008(1).pdf)
and Pakistan and Iran. Early eighties is especially mentionable in this regard when a full fledge governmental effort were noticeable to Islamize the entire economy in Pakistan, Iran and Sudan, which we will discuss in the following sections.

3.2.3.1 Islamic Banking in Pakistan

It was first attempt of any modern Muslim State towards the Islamisation of its economy. In September 1977 the President of Pakistan asked the Council of Islamic Ideology (CII) the top Islamic body of experts that advises government of Pakistan on religious issues to prepare a blue print of an interest free economic system and set a time limit for three years for the elimination of riba from economy. The council appointed a panel of economists and bankers, which submitted its reports in February 1980, which after several consideration and modification adopted in the year 1980. And by January 1981, all domestic commercial banks were allowed to accept deposit on the basis of profit and loss sharing (PLS). Over the next three years, steps were taken to develop new non-interest bearing financial instruments in which PLS deposit could be invested. Further steps were instituted in January 1985 to formally transform the banking system to one based on no interest within next six months. However, transaction with the government continued to be based on interest. The Supreme Court of Pakistan in its landmark judgment ordered the government of Pakistan to transform whole of its financial system in tune with Shari‘ah Compliance by July 2001. In a landmark decision, the Supreme Court in Pakistan in January 2000 has ordered that the country convert its financial system to an Islamic one by June 2001.

Islamic banking has been re-launched in Pakistan since 2002/03. The Islamic banking system has witnessed a very healthy growth during the last couple of years and is steadily proving its potential to work as a compatible and parallel

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alternative system for providing financial services. It is growing in terms of size and structure. Growing at a rate of 114 percent, total number of branches increased to 150 in 2006 from 70 in 2005.

The growing interest in Islamic banking in the year 2006 is also evident by the entry of three new conventional banks having Islamic banking branches. These include Askari Bank Limited, United Bank Limited, and National Bank of Pakistan. Moreover ABN Amro has also started operations in second quarter of the 2007, making the tally of conventional banks having Islamic Banking Branches to thirteen. It is interesting to note that the conventional banks are increasingly realizing the huge potential market backed by the untapped and steadily growing appetite for Islamic banking products; hence the drive for entering this market is based on business considerations in addition to religious considerations.

In addition to existing full-fledged Islamic banks namely Meezan Bank, AlBaraka Bank, two new Islamic banks namely Bank Islami Pakistan Limited and Dubai Islamic Bank Pakistan Limited started their operations in the 2006. Moreover another two full fledge Islamic banks namely Emirates Global Islamic Bank Limited and First Dawood Islamic Bank Limited have since started their operations by the start of second quarter of the 2007. As on April 17, 2007, the 6 full-fledged Islamic and 13 conventional banks have a total of 108 and 58 branches respectively. They have presence in 25 cities & towns cover all the four provinces of the country.\(^{21}\)

### 3.2.3.2 Islamic Banking in Sudan

Sudan is one of the three countries (the others are Iran and Pakistan) where the whole banking system has been converted into Islamic banks. The process of Islamic banking started in 1977 with the establishment of Faisal Islamic Bank, Sudan (FIBS). By 1983 three more banks had opened Tadamun Islamic Bank, Sudan. (FIBS). By 1983 three more banks had opened Tadamun Islamic Bank,
Sudan (TIBS), Sudanese Islamic Bank, and Islamic Co-operative Bank. In September 1983 the whole Financial System of Sudan was started to be converted to the Islamic model.

During the period of 1985-1989 many of the recently converted Islamic banks were reverted back to their original conventional operations. This is the period when Islamic banks were forced to operate in an extremely hostile environment characterized by negative media coverage, lawsuits and heavy regulations. Since 1989 after the coming into power of the Islamic Salvation Front, the whole economy has again been transformed to confirm to the Islamic Law. As of July 2006, there were 24 Islamic banks and financial institutions in Sudan. Presently, Sudan holds over half of Africa’s Islamic-banking assets. A number of Gulf banks, familiar with the country’s language and oil resources, have joined forces with Sudanese investors to open Islamic banks.

3.2.3.3 Islamic Banking in Iran

Following the Islamic revolution in 1979 the Iranian authorities took steps to bring the banking system’s operation into correspondence with the requirements of Islamic Law. In June 1979, Iranian banks were nationalized and then banking regulations changed with the approval of the Islamic banking law (interest free). Since February 1981 the Bank Markazi (Central Bank Iran) started taking administrative steps towards elimination of interest from banking operations. A high level commission composed of bankers, academics, businessmen and Shariah scholar prepared legislation for the elimination of riba from the economy which was passed by the parliament in August 1983 as the law for usury free banking. The law required the banks to convert their deposits in line with the Shariah

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24 [http://giz.blogs.com/search/label/Sudan](http://giz.blogs.com/search/label/Sudan)
25 This Islamic Banking law was passed by the Islamic Majlis of Iran, See “interest-free banking law”. Central Bank of Iran available at [http: www.cbi.ir/simplelist-1457.aspx](http: www.cbi.ir/simplelist-1457.aspx)
within one year, and their total operations within three years, from the date of passage of the law, and specified the types of transactions that must constitute the basis for assets and liabilities acquisition by banks.26

In brief, the process of Islamization of the banking system in Iran has gone through three different phases. In the first phase (1979-82), the banking system was nationalized, restructured, and reorganized in order to remove the weaknesses of the system.

The second phase began in 1982 and lasted until 1986. In this phase a legislative and administrative step was made in adopting and implementing a clearly expressed model of Islamic banking. The Law for Riba-Free Banking was passed in August 1983 giving a very short deadline of 1 year to the banks to convert their deposits in line with Islamic law and their total operations within 3 years from the date of the passage of the law.

The third phase, which began in 1986, defines a role for the banking system different from the earlier phases, in that the system was expected to be an integral part of the government and, thus, a direct instrument of its policies. Much of the trend in Islamic banking in Iran has been influenced by factors that have their roots in the pre-revolutionary economic structure, as well as post revolutionary external and internal political developments.27

3.2.4 Islamic Banking in South Asia

Bangladesh

In August 1974, Bangladesh signed the Charter of Islamic Development Bank. Bangladesh committed itself to re-organize its economic and financial

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system as per Islamic Shariah. Earlier, in November 1980, Bangladesh Bank sent a representative to study the working of Islamic banks abroad. In November 1982, IDB came forward to establish a joint venture Islamic bank in the private sector. Two professional bodies, "Islamic Economics Research Bureau" (IERB) and "Bangladesh Islamic Bankers Association" (BIBA) made a significant contribution to Islamic banking in the country. They trained up top bankers and economists and held seminars, symposia and workshops to mobilize public opinion for Islamic banking. A number of entrepreneurs strengthened their activities by mobilizing equity capital for the emerging Islamic bank. As a result, Islami Bank Bangladesh Limited which is considered to be first interest-free bank in South East Asia, was incorporated on 13th March 1983. Subsequently, four other Islamic banks have emerged in the private sector which were incorporated as public limited companies. Now, there are many Islamic banks, insurance companies and business enterprises in the country.

Al Baraka Bank Bangladesh Limited (Al-Baraka); the second Islamic bank of the country, it commenced banking business as a scheduled Islamic bank on May 20, 1987. Al-Arafah Islami Bank Limited (Al-Arafah) was incorporated in 1995 and started operation as 3rd Islamic bank in the private sector banking in Bangladesh from September 1995. Social Investment Bank Limited (SIBL); the fourth Islamic bank in Bangladesh. It was incorporated in 1995. Faysal Islamic Bank of Bahrain (FIBB) started operating in Bangladesh with effect from 11th August 1997.28

Besides these Islamic banks, two other private banks namely the Prime Bank Limited has opened two Islamic banking branches in 1995 and 1997 respectively and the Dhaka Bank Limited opened an Islamic banking counter to deal with the Islamic banking business parallel to the conventional banking

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operations since inception of the bank on July 1999. There are more three private commercial banks operating as full-fledged Islamic banks viz. Export Import Bank of Bangladesh Ltd. (established in 1999), which has migrated all of its conventional banking operation into Shari’ah based Islami banking since July 2004. The Oriental Bank Bangladesh Ltd. was incorporated on April, 1987 as a public limited company. While Shahjalal Islami Bank Ltd. was incorporated on April 2001.

Thus, at present, out of 49 banks in Bangladesh, 6 private commercial banks are operating as full-fledged Islamic banks and 10 conventional banks are partially involved in Islamic banking in a total of 20 branches. They have passed about two decades of successful Islamic banking operations in Bangladesh.

The Islamic banking industry in Bangladesh continued to show strong growth since its inception in 1983 to June 2006 as reflected by the increased market share of the Islamic banking industry in terms of assets, financing and deposits of the total banking system. The products being offered by these banks range from consumer credit to long term finance for big investment projects.

The Islamic banks in Bangladesh started from a very limited resource base right from the beginning. But with the passage of time, they have excelled strong performance in respect of mobilization of deposits as well as in investments.

The Statutory Liquidity Requirement (SLR) for the Islamic banks is fixed at 10 percent since inception of first Islamic Bank in 1983. This has remained unchanged till date while SLR for the traditional commercial banks has been

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29 Ibid.
31 Total deposits of the Islamic banks and Islamic banking branches of the conventional banks stood at Taka 232981.00 million at end June 2006. This was 28.46 percent of the deposits of all private commercial banks and 9.67 percent of the deposits of the total banking system at the end of June, 2006. Total investment of the Islamic banks and the Islamic banking branches of the conventional banks stood at Taka 210493.80 million at end June 2006. This was 29.35 percent of all private banks and 14.88 percent of the total banking system of the country. (Source: Bangladesh Bank)
changed several times which presently is fixed at 18 percent. The low requirement of SLR for Islamic banks is due to the non-holding of interest bearing types of eligible securities. In order to overcome the situation, the central bank of the country viz. Bangladesh Bank issued an Islamic Bond on behalf of the government namely “Government Islamic Investment Bond (GIIB)” in October 2004, which is governed by the Islamic Shariah. However, efforts are underway to develop Islamic inter-bank market instruments to help banks in managing their liquidities.

**India**

A country, which can rightly be credited to have played a pioneering role in the development of Islamic finance and interest free credit societies, a country that has produced many prominent writers of the contemporary Islamic finance world, is yet to grant permission for Islamic banks in the country. Present Banking regulations of the country do not allow to operate interest free banking system. To cater for their need Muslims in the country have taken the route of cooperative credit society and non-banking finance corporations (NBFC), the prominent among them have been Bait-un-Nasr and Barkat Group of Bombay, Al-Ameen Group of Bangalore and Muslim Fund Group of Najibabad.

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32 Excess liquidity of the Islamic banks and Islamic banking branches as well stood at Taka 8956.80 million as at end June 2006 (19.08 percent of private banks and 8.19 percent of all banks) which originated due mainly to the non-responsiveness of the good borrowers for investment demand and absence of adequate interest free financial instruments and an organized Islamic money market in the country as well.

33 Inputs taken from [http://abdullahalharon.blogspot.com/search label=Bangladesh; Islamic Banking in Bangladesh by Umar Faruq Ahmad, a thesis submitted in fulfillment of the requirement of master of Laws (Honours), University of Western Sydney, School of Law, April 2002., Abdul Awwal Sarker, “Regulation of Islamic Banking in Bangladesh: Role of Bangladesh bank”, International Journal of Islamic Financial Services Vol. 2 No.1 (http://www.iiibf.org/journals/journal5/art3.pdf)]

34 See the above sections, ‘Spread of Islamic Finance & Banking Industry and ‘Islamic Banks established before 1980s’.

35 The Government’s laws and regulations are too stringent to open a bank operating on shariah norms. These require amendments at Central Government level e.g. The RBI Act, The Banking Regulation Act, N.I. Act etc.

Barkat Group established in 1983 is an offshoot of Bait-un-Nasr Bombay this group flourished very fast till 1997. All India Council of Muslim Economic Upliftment (AICMEU) and Baitul Maal of Bombay were established in 1984, while Al-Ameen, Bangalore, started its business in 1986. Syed Shariyat and Al-Baraka Finance House Ltd. (Now Al-Barr) were established in 1989. Baitul Islam and Assalam Finance and Investment were established in 1990.

In 1994 Barkat and Muslim Fund Al-Najib group joined together to market aggressively the concept of Islamic finance. This tie swelled up the deposits to Rs. 550 million with 60 Branches all over India.

In the year 1996 Barkat Investment Group along with some other Islamic financial institutions convinced India's premier business house the Tata Group to launch a mutual fund scheme specially designed for Muslims in view of their inhibitions towards interest. The scheme named ‘Tata Core Sector Equity Fund’ TCSEF succeeded in raising Rs. 230 million from the public.

The non-banking financial companies (NBFCs) crisis during late 1990s resulted in revocation of the licenses of many Islamic financial institutions and after the liquidation of Barkat Investment Group in May 2000, the Islamic financial activities, in India, have got big setback. With the closure of Bait-un-Nasr (the oldest and most professionally managed cooperative society), the future of Islamic financial institutions in the country looks bleak.

Over the past few years, Islamic banking as a concept esp. Islamic Investment has gained momentum in India and its scope in India's liberalized
financial market has been explored. Several foreign banks operating in India, like Citibank, Standard Chartered Bank, HBSC (are operating interest free windows in several West Asian countries, Europe and USA) has shown keen interest to open such windows here. There is also a growing awareness about the concept among Indian banks and it is generally felt that there is a huge potential market in India for Islamic banking products.

Several banks in the country have shown an inclination to undertake this form of interest-free banking. This has led the Reserve Bank of India to set up a committee headed by Mr Anand Sinha, chief general Manager in-charge, department of banking operations & development to look into the matter. Islamic organisations like Jamat-e-Islami are taking an active interest in seeing it through; and they have organized many seminars of Islamic scholars and former bankers on this theme to mobilize the public opinion. In February, 2006, Jma’at-e-Islami organized an international Seminar on the theme ‘Justice and Equity: The message of Islamic Banking’. Its Islamic banking committee has recently formed an organization named ‘Indian Centre for Islamic Finance’ (ICIF) to advocate and promote the idea of Islamic banking and mobilize the opinion of government authority and Reserve Bank of India (RBI) for the feasibility of such system so that they may look into the matter seriously. ICIF is also involved to have prepared a feasibility report from an independent body of reputed consultant for the Islamic Banking in India to be submitted to the Government and RBI for serious consideration. Of late, many such efforts have being taken by individuals, groups & organization to persuade the government to ease the RBI regulations or be amended them to accommodate Islamic (interest-free) banking in India.

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40 For detailed discussion on the subject, see Khan Javed Ahmad (2003), “Islamic Banking in India: Scopes & Challenges”. Institute of Objective Studies, New Delhi
41 The committee was set up in 2005 to seek out the scope of Islamic banks in India but the committee in its presented report had denied any chance to open any banks in present existing condition of RBI.
42 In February 2006, a meeting was held in Saudi Arabia, which was attended by Dr. Man Mohan Singh, the Prime Minister and Shri. Chidambaram, the Finance Minister when the local banks expressed a desire to make investments in India. The Prime Minister responded positively. As a result, the idea of opening
Muslim organization and businessmen have recently submitted a proposal to the planning commission of the country for setting up Islamic bank (which would not charge interest on loans etc, under Islamic norms) with the help of Islamic Development Bank (IDB), Jeddah.

But there is yet to receive any positive response to introduce the system on the part of government.

Presently in India, Islamic banking is confined to the co-operative sector. They are actually non-banking finance companies (NBFCs), which work on non-profits-no-loss basis. There are several Baitul Mal working in cities as well as in villages. These Muslim financial Institutions (MFIs) by and large cater to the needs of local area except a few that operate across districts or states. Their sources of funds are limited and as a result these banks have to operate on small scale missing the economies of scale. However, these interest free financial institutions have not succeeded in registering higher growth or making an impact on Indian economy because the financial authorities have yet not made provisions to boost their operation nor developed the necessary regulatory mechanism for them, including appropriate changes in the tax laws.

These MFIs particularly provide housing loan (on the basis of co-ownership, venture finance on Mudarabah, and Musharaka basis) consumer, personal, educational, automobile and several other loans as per their individual terms and conditions. Some also finance transports and trade on the mark up basis via hire purchase. They invest in government securities, small savings schemes or

branches of Muslim banks in India got an impetus and in this connection, on 16th and 17th September, a seminar was organized in Mumbai. In this seminar, the legal hurdles in opening branches was weighed, which regulations of RBI can come in the way of establishing the Islamic Banks and its solutions was examined. (Islamic Banking in India: Muslims stratagems to establish separate Muslim economy. Daily Sanatan Prabhat, Sept, 19. 2006. http://intelbriefs.blogspot.com/2006/09/islamic-banking-in-india-muslims.html)

43 (Muslim Businessmen ask govt to start Islamic banking in India, The Economic Times, 18 May 2008)  
http://economictimes.indiatimes.com/News/News_By_Industry/Banking_Finance_/Banking/Businessmen_ask_govt_to_start_Islamic_banking_in_India/rssarticleshow/3050439.cms
units of mutual funds and in shares of companies for earning profits. Hire-purchase and lease finance are other source of investments.

These banks do not function under banking regulations. They are licensed under Non Banking Finance Companies Reserve Bank Directives 1997 RBI (Amendment) Act 1997, and operate on profit and loss based on Islamic principles.44

Many private sector financial players have started Mutual Funds conform to Shari‘ah principle such as NBFCs like Parsoli Corporation Limited, Idafa Investments Pvt. Ltd., Alternative Investments and Credit Ltd. (AICL) Cochin, Sayyed Shariat Finance Ltd., Al-Barr Finance House Limited (India) etc. Kotak Mahindra Mutual Fund has launched an Islamic fund worth $300 million to enable Islamic investors to invest in Indian stocks in a shariah-compliant way. A few months ago, a Bangalore-based venture capital firm named ‘2iCapital’ placed 250 million in an Islamic fund. Kuwait-based Khaleej Finance and Investment also recently invested $250 million in shariah-compliant venture in India and Beary's Investments, a Middle-East investment group45, made an investment of over $50 million in real estate in Bangalore. This suggests that India is emerging as an investment destination for global Islamic investors.46 An Ahmedabad-based stock brokerage firm that adheres to Islamic investment norms created47 India's first Islamic equity stock index, the Parsoli Islamic Equity Index.48

45 Saudi Economic and Development Company (Sedco) and Bearys Group which have come together to invest $20 million for the Bearys Global Research Triangle in Bangalore. http://et.indiatimes.com/islamic_investors_focus_on_india_china/articleshow/2734329.cms
46 (Islamic investors focus on India, China, The Economic Times, 27 January, 2008)
47 (Islamic funds bullish on India, by Zeeshan Ahmed, Ahmedabad, Rediff News, Aug. 9, 2007)
48 According to its director, Uvesh Sareshwala, “Export earnings of Gulf countries have gone up and all of it can’t be invested locally due to little economic activity in Arab countries. Even though Islamic investors turned to Islamic countries like Malaysia, Pakistan and Indonesia, their economies provide limited opportunities and too inadequate to absorb the huge investment potential of the Arab Islamic countries. So,
Thus the stock market and Mutual funds, which most Muslims earlier avoid, are now grabbing the opportunities since the entry of two major investment institutes Parsoli Investment and IDAFA investment. At present Parsoli Corporation Ltd is the biggest known investment company that is listed on Bombay Stock Exchange and Ahmedabad Stock Exchange and has the nexus with network-18 group, however it has been working since 1990. Besides this, IDAFA investment Pvt. Ltd (www.idafa.com) is another investment firm constituted in 1994 to invest money in Mutual Funds and stock market in a way that does not violate the Shari'ah principles.

**Sri Lanka**

Sri Lanka is one of the few non-Islamic countries to have legislation for the Islamic banking sector. Following amendments to the Banking Act No 30 of 1988 in March 2005 to allow Islamic banking products, there is now adequate flexibility for conventional banks to establish Islamic banking windows and launch Islamic financial products. The two existing conventional commercial banks- namely Union Bank and MCB of Pakistan- opened Islamic windows in the country. However, efforts in strategic marketing communication to promote and raise awareness of these products are still in the infancy stage.

The Central Bank of Sri Lanka (CBSL) has already authorized Islamic banking to be carried out in licensed commercial banks as a regulated and legal activity. However, CBSL is further studying the Islamic banking concepts while senior Muslim ministers are backing an initiative to allow full-fledged Islamic banks to operate in the country.

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*the Islamic investors are now coming forward to invest in India, as it is the best option with a large number of companies qualifying Shari'ah investment norms.*

49 *India: Shariah-compliant plans are flavour of the season for mutual funds*, The Economic Times, 20 May, 2008. [https://blogspot.com/2008/05/india-shariah-compliant-plans-are.html](https://blogspot.com/2008/05/india-shariah-compliant-plans-are.html)


51 Now acquired by Standard Chartered Bank, Pakistan.

52 The Islamic window of People’s Leasing Company

53 *Interest Picking up in Sri Lanka’s Islamic Market*, *Islamic Finance News* 2008, p.95
There have been some efforts at village and provincial levels to create Islamic fund-type operations, but their success has been limited. Some Islamic microfinance institutions in the rural are offering limited service in small communities.

Islamic financial services providers currently active there include Amana Investments Limited, Ceylinco Islamic Investment Corporation (CIIC), Muslim Commercial Bank (MCB), National Asset Management Limited (NAMAL), People’s Leasing Company, First Global Investments Group and ABC Investments.

Amana Investments Ltd.\(^\text{54}\) (established in 1997), which is a 48% foreign-owned public limited company with Bank Islam of Malaysia holding 10%, leads the country’s Islamic financial services market. It is now at the head of the queue for a license to operate as a fully fledged Islamic commercial bank in the country. Its subsidiary Amana Takaful Ltd (ATL) began operations in June 1999 and is acknowledged as the market leader for Takaful services. ATL was listed on the Colombo Stock Exchange in late 2006.

Ceylinco Islamic Investment Corporation (CIIC) made its entry in 2003 and is fully backed by Ceylinco Insurance, one of the leading conventional insurance providers in Sri Lanka. It offers both selected Shari'ah compliant and Takaful products.\(^\text{55}\)

In Nov. 2007, National Asset Management Limited (NAMAL)\(^\text{56}\) together with Amana Capital (a subsidiary of Amana Investments), launched the NAMAL

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\(^\text{54}\) The Amanah Group is involved in the provision of Islamic Finance, Insurance, fund management, stockbroking and corporate advisory services. It has obtained regulatory license for Islamic insurance (2002), fund management and stockbroking activities (2006).


\(^\text{56}\) The first fund management company in Sri Lanka licensed to manage unit trusts and a subsidiary of DFCC Bank, which is a large development bank in the country.
Amana Equity Fund to primarily invest in equity securities that are Shari'ah compliant.

First Global Group is a public limited finance investment company that deals with Shari'ah compliant investments and financing products and services. Domestically, it is the first institution to promote training and career development programs related to Islamic banking and finance.

Finally, there's ABC Investments Ltd. (Baraka Islamic Financial Service), established on 18th July 2007, operating only in the capital Colombo, now plans to expand their business with branches outside the capital including rural areas and wants to become a full fledged Islamic bank as soon as regulators allow it.\(^{57}\)

In March 2007, The Dow Jones Islamic Market AMANA Sri Lanka Index\(^{58}\) the first Shari'ah compliant and co-branded stock market index on the Colombo Stock exchange, was launched. There are 10 stocks in the Index which is reviewed on a quarterly basis. As of March 23, 2007, the year-to-date performance of the index is 3.07%\(^{60}\).

The Takaful concept was introduced in the country in 2002, with the entry of Amana Takaful Ltd (ATL).\(^ {61}\) A second Takaful operator, Ceylinco Takaful Limited, made its debut in mid-2006. Sri Lanka Insurance Corporation Limited\(^{62}\)...

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\(^{57}\) Lanka Business Online (LBO), (2007), Sri Lanka Islamic investment group to go rural, July 22, (http://www.lankabusinessonline.com/fullstory.php?newsID=1930869284&no_view=1&SEARCH_TERM =2)

\(^{58}\) Dow Jones Islamic Market Index suite was originally created in 1999 and continues to serve as the premier benchmark family for Islamic-based equity portfolios. DJIM Indexes combines Islamic investment principles with Dow Jones Indexes' objective, transparent and rules-based methodology.

\(^{59}\) The index involves tracking the performance of Sri Lankan companies that comply with Shari'ah-based investment principle and provides the investors access to stocks suitable for Islamic investment. It is designed to underlie financial products such as mutual funds, exchange-traded funds and other investment vehicles, and weighted by float-adjusted market capitalization and component weights are capped at 15%.

\(^{60}\) NEW YORK, March 26, 2007 (PRIME NEWSWIRE), Sri Lanka/Dow Jones Indexes and AMANA Securities Limited Launch First Islamic Index for Sri Lanka Financial News - Yahoo! Finance.htm

\(^{61}\) ATL has been recently ranked 203rd in the world's first comprehensive “Top 500 Islamic Financial Institutions” published by The Banker, the global finance magazine of the Financial Times Group, in its November, 2007 issue. It accounted for US$5.55 million worth of Shari'ah compliant assets.

\(^{62}\) The country's largest and strongest composite insurance provider with LKR 50 billion worth of assets under management.
has also announced its intended foray into Takaful. Two of the country’s largest insurance operators (Ceylinco Life and Sri Lanka Insurance Corporation) also plan to offer Takaful products. The housing bank, HDFC bank of Sri Lanka has recently planned to offer housing mortgages based on Islamic finance principles.

Thus there is now much interest among the conventional players to enter the market. The state owned Bank of Ceylon and Lanka Oreint Leasing Company are also on the verge of entering the market through window type operations. Some of the foreign banks also plan to open Islamic banking windows.

Malaysia based International Center for Education in Islamic Finance (INCEIF) recently (2007) established the faculty of Islamic banking and finance, the first in Sri Lanka as an affiliate with Sri Lanka-based Ceylinco Sussex Business School (CBS) to offer the Certified Islamic Finance Professional (CIFP) qualifications so as to meet the needs of human capital for the Islamic financial services industry in Sri Lanka as well as those of neighbouring countries.

At present, the size of the Islamic market sector is estimated at US$ 750 million, growing at about 15% per annum.

3.2.5 Islamic Banking in South East Asia

Malaysia:

Malaysia is one of most dynamic and vibrant economies in the Southeast Asian region that is actively contributing toward economic development of

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65 INCEIF was established by Bank Negara Malaysia in December 2005 to contribute towards the global development of human capital that is required to support the future growth and development of the global Islamic financial industry. With the aim of producing high-calibre practitioners and professionals in Islamic finance as well as specialists and researchers, INCEIF has become a platform for training in this area.
Southeast Asia. Of late, Malaysia has emerged as an important center of Islamic banking. It has the privilege of having the first Islamic bank of the region. Over the last thirteen years, Malaysia has taken many steps of far reaching implications by introducing Islamic banking services at a much large scale that signifies its high status and substantial significance in global Islamic banking and finance industry. Malaysia is probably the only Muslim country that has substantially did well in developing a strong indigenous Islamic banking and financial sector. It has succeeded in implementing a dual banking system and has emerged as the first nation to have a full-fledged Islamic banking system operating side-by side with the conventional banking system.

In Malaysia, Islamic finance traces its root back to 1963, with the establishment of the Pilgrims Fund Board or Lembaga Tabung Haji (LTH). This was a savings mechanism under which people set aside regular funds to cover the costs of performing the annual pilgrimage. These funds were in turn invested in productive sectors of the economy, aimed at yielding return untainted by riba'.

Like Tabung Haji, the Bank Partainian Malaysia (BPM) which was established as a traditional agriculture bank, also formulated some interest free credit schemes as early as 1969 to serve mainly Muslim Malay farmers.

However, Islamic banking started taking roots in Malaysia in early eighties. In 1981, National Steering Committee (NSC) was set up in order to undertake a study and recommend to the government the feasibility of establishing an Islamic bank in the country. An outcome of the study was the foundation of the first Islamic bank in Malaysia, Bank Islam Malaysia Berhad (BIMB) in July 1983, with an initial authorized capital of RM600 million and a paid up capital of RM80 million (followed by the establishment of Takaful operator^7 (Syarikat Takaful

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^7 In 1984, the Takaful Act (TA) was enacted that paved the establishment of Syarikat Takaful Malaysia. This act governs the conduct of Takaful business.
Malaysia Berhad), 1984). The bank has gradually increased its authorized and paid up capital to RM 2 billion and RM 563 billion respectively as of January 2007. It was listed on the Main Board of the Kuala Lumpur Stock Exchange (KLSE) on 17 January 1992. The legal basis for the establishment of Islamic banks in the country was the Islamic Banking Act (IBA) which came into effect on 7 April 1983.

The Government Investment Act 1983 was also passed at the same time to empower the Malaysian Government to issue Government Investment Issue (GII), which are government securities issued based on Saria'h principles.

On 4 March 1993, the central bank, Bank Negara Malaysia (BNM) introduced an interest-free banking scheme known as "Skim Perbankan Tanpa Faedah" (SPTF) to allow conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including staff and branches (window system). In this regard, the Banking and Financial Institution Act (BAFIA) 1989 was also amended to enable conventional banks to conduct Islamic banking business. This marked the launch of a dual-banking system in Malaysia i.e. Islamic and conventional banking. Since then, the number of Islamic financial institutions has increased to 36, comprising 14 commercial banks (of which 4 are foreign banks), 10 finance companies, 5

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68 'The History of Islamic Banking in Malaysia' an article available at website of Bank Negara Malaysia (BNM), the Central Bank of the country (http://www.bnm.gov.my/index.php?ch=174&pg=469&ac=382)
69 After more than a decade in operations, BIMB has proved to be a viable banking institution with its activity expanding rapidly throughout the country with a network of 82 branches. Its total assets rose from RM325.5 million in 1984 to RM 19.09 billion in 2007.
70 The IBA provides BNM with powers to supervise and regulate Islamic banks, as in the case of other licensed banks.
71 http://islamic-world.net/islamic-state/malay_islambank.htm
72 As the GII is regarded as liquid assets, the Islamic banks could invest in the GII to meet the prescribed liquidity requirements as well as to invest their surplus funds.
74 The dual system was officially launched on 4 March 1993 on pilot basis involving three banks. Following its success, BNM allowed other commercial banks to operate the scheme from July 1993.
merchant banks and 7 discount houses. To link the institutions and the instruments, the Islamic Inter-bank Money Market (IIMM) was introduced on 4 January 1994. In October 1996, the central bank, issued a model financial statement for conventional banks participating in the Islamic windows schemes, requiring them to disclose their Islamic banking operations (balance sheet and profit and loss account). As part of the effort to streamline and harmonize Shari‘ah interpretations among banks and takaful companies, BNM also established the National Syariah Advisory Council on Islamic Banking and Takaful (NSAC) on 1 May 1997 as the highest authority. On 1 October 1999, the second Islamic bank, Bank Muamalat Malaysia Berhad, was established.

A higher learning institute, a college of Islamic Banking and Finance, popularly known as KPKI (Kolej Perbankan dan Kewangan Islam) was established in 1998 to give a boost to the knowledge of Islamic banking. Among the measures implemented in 2001 to further develop and strengthen the regulatory framework of the Islamic banking industry were the adoption of Risk Weighted Capital Ratio (RWCR) framework; the implementation of Rate of Return (ROR) framework; and the implementation of training and awareness programmes. In the area of research and training in Islamic banking and finance, an industry-owned institute named Islamic Banking and Finance Institute Malaysia (IBFIM) was established.

As at July 2007, 11 full-fledged Islamic banks, 8 commercial banks, 4 investment banks and 5 development financial institutions were offering Islamic banking services. (Source: Bank Negara Malaysia.)

IIMM was mainly established in order to hasten the growth of Islamic banking in Malaysia as a short term intermediary to provide a ready source of short term investment outlets based on Shari‘ah principles. Only Islamic banks, commercial banks, merchant banks, eligible finance companies and discount houses are allowed to participate in the IIMM.

Islamic Banking and Finance Institute Malaysia Sdn. Bhd. (IBFIM) was launched on 19 February 2001, dedicated to produce well-trained, high caliber individuals and management teams with the required expertise in the Islamic finance industry.

As at July 2007, 11 full-fledged Islamic banks, 8 commercial banks, 4 investment banks and 5 development financial institutions were offering Islamic banking services. (Source: Bank Negara Malaysia.)

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Malaysia is in a boom-mode for the last five years, with high profitability and high growth. The growth has been much faster where Islamic banking has a 12 per cent market share. By the end of June 2006, total asset of Islamic banking industry stood at RM 117.448 billion whereas total financing and total deposit amounted to RM 69.82 billion & RM 86.216 billion respectively.

In June 2005, Dow Jones Company of New York and RHB Securities of Kuala Lumpur, teamed up to launch a new "Islamic Malaysia Index". Islamic capital market products such as sukuk and bonds have dominated the capital markets in recent years. The Survey Magazine published by the International Monetary Fund said Malaysia is the world's largest Islamic bond market with an estimated value of US$47 billion, accounting for two-thirds of the global total. Malaysia issued its first sovereign five-year Islamic bond or sukuk of US$600 million in 2002.

Malaysia has played important role in establishment of the International Islamic Finance Market (IIFM) and the international standard-setting body both to be based at Malaysia and it has also taken a leadership role in establishing

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81 Market share of Islamic banking sector (as at March 2006); Assets: 11.6% or RM113.5 b; Deposits: 11.6% or RM85.0 b; Financing: 15.7% or RM67.5 b; Growing at 19% p.a. since 2000. Market share of takaful sector (as at March 2006); Assets: 5.9% or RM6.2 b and Islamic Capital Market: Private Debt Securities- RM 125 b, 46% Market Share, Equities- over 80% counters Shari'ah compliant, over 70 Islamic unit trusts. (Source: Bank Negara Malaysia)
82 In 2006 Malaysia's Islamic banking assets amounted to about 13% of the total banking sector, while takaful has been growing at an average rate of 27% annually for the past five years. The sukuk market is expanding and some 56% of sukuk issued globally originate from Malaysia. New incentives introduced in the 2008 budget included allowing up to 70% foreign ownership of fund management companies and real estate investment trusts (REITs). (Annual Business Economic and Political Review: Malaysia (2008), Islamic Financial Services, vol. 3, Issue: 1, May 14. pp. 85-94)
83 A collection of 45 stocks representing Malaysian companies that comply with a variety of Sharia-based criteria. Three variables (the total debt of an indexed company, its total cash plus interest-bearing securities and its accounts receivables) must each be less than 33% of the trailing 12-month average capitalization, for example. http://www.rhislamicbank.com.my/index.asp?Fuseaction=LearningMain&recID=78; Thus, Dow Jones RHB Islamic Malaysia Index lists 74 Shariah compliant counters (< 10% of total listed securities) Total market capitalisation is RM192 billion (~28% of total) as of end-2005
84 http://gifc.blogspot.com/ (Malaysia To Build On Leading Edge In Islamic Banking, Friday, 30 November 2007)
institutions such as the Islamic Financial Services Board (IFSB) and the International Centre for Education in Islamic Finance (INCEIF)\(^5\). The INCEIF set up in March 2006 to develop human capital and R&D in Islamic finance, has forged strategic alliances with renowned local and international institutions of higher learning.\(^6\) Efforts were also intensified to enlarge the pool of talent in the field of Syariah by providing scholarships and research grants funded by Bank Negara's Endowment Fund for Syariah Scholars in Islamic Finance.\(^7\)

As of July '07, there were three new foreign banks owned by Middle East investors namely Kuwait Finance House, Al Rahji Banking and Investment and Asian Finance Bank. These banks have rapidly expanded their branch network to a total of 15 branches, since the commencement of operations of the first foreign Islamic bank in August 2005.

After 23 years of developing and regulating an Islamic Financial system called as a progressive model, Malaysia is to entrench itself as a global hub for Islamic Finance by taking measures to enhance inter-linkages in the global islamic financial markets. Malaysia International Islamic Financial Centre (MIFC)\(^8\) was launched in August 2006 to offer Islamic financial products and services in international currencies from anywhere in Malaysia. The MIFC initiatives aim to provide operational flexibility, cost-effectiveness and a conducive environment for Islamic finance business in international currencies. Under (MIFC) initiative, Bank Negara Malaysia is inviting more new players, local and foreign in IB sector.\(^9\) To conclude, Malaysia has achieved significant milestones in building comprehensive and integrated Islamic financial system with diversity of players.

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\(^5\) The IFSB, which has a membership of 125 countries, works to co-ordinate regulations and standards internationally, whereas INCEIF is a university-level institution that develops human capital to meet the needs of the Islamic finance sector.

\(^6\) http://www.alhudacibe.com/newsletter/1-15nov/article_3.html


\(^8\) It allows foreign players to conduct Islamic financial services in the country through a local entity or branch.

Indonesia:

Sharia banking in Indonesia was formally launched in 1992 by the issuance of Act Number 7 on dual banking system. To support network expansion and to better encourage the development of sharia banking in the country, Act No.7 was further amended through Act No. 10/1998. An important change in this Act is the opportunity for conventional banks to open Sharia unit and implement the dual banking system.

During the period 1992 to 1998, there was only one sharia commercial bank and 78 sharia rural banks came into operation. In 1998, the Act No. 10 of 1998 on the amendment of the Act No. 7 of 1992 concerning banking came into force to give stronger legal foundation for the existence of sharia banking system. The new Act No. 23 of 1999 concerning Bank Indonesia gives an authority to Bank Indonesia to also conduct its task according to sharia principles. Since then, sharia banking industry has been growing more rapidly.

During the period 1998 to 2001, sharia banking system has grown quite rapidly at about 74 percent annually (in terms of asset size) from Rp. 479 billion in 1998 to Rp. 2,718 billion in 2001. The sharia banking system has also developed institutionally.

In spite of its rapid development, sharia banking system still acquires a small portion of market share (approximately 0.26% of the total asset size of the national banking system). Many steps have been taken to improve the operational quality of the sharia banking in order to gain public confidence and customer satisfaction.90

In 2003, the “Blueprint for the Development of Shariah Banking in Indonesia” (Cetak Biru Pengembangan Perbankan Syariah Indonesia) was produced by the Shariah Bureau of Bank Indonesia, the country’s Central Bank.
Indonesia, has come to Islamic or shariah banking fairly late. In 1997, the country had only one Syariah commercial bank. However, the growth of Syariah banking during the last five years has been somehow phenomenal with a consistent above 48% asset growth annually since 2001 (since 2003, the growth rate has been above 94%). As of June 2005, there are now 3 Syariah banks and 20 Syariah Banking Units (these are conventional banks which have been granted Syariah banking licenses). Presently the sharia banking area accounts for about 2 percent of total funds held in Indonesian financial institutions. Before 2003 the practice was extremely rare and has only come into prominence due to the Indonesian Ulema Council fatwa of that year declaring bank interest to be an illegal profit, or “riba”.

On August 24, 2006 Bank Indonesia has enacted a new circular letter for sharia banking i.e. NEW GUIDLINES FOR SYARIAH SUPERVISORY BOARD IN SYARIAH BANKING.

From 2006 all funds held by the government in hajj pilgrimage accounts will be given over to the sharia compliant bank system. Some 200,000 Indonesian pilgrims each year pay 25 million rupiah, or about $2500, up to a year in advance, to go to Mecca. The government is also lowering the capital requirement for setting up new sharia banks from 3 trillion rupiah to 1 trillion. The central bank estimates that by 2011 the share of the sharia compliant sector will rise to about 10%. Total assets of Islamic banks in Indonesia are likely to more than triple by the end of next year because of growing demand for Islamic financing instruments, the central bank said. Total assets of Islamic banks are expected to rise to 91.57 trillion rupiah ($9.95 billion) by the end of 2008, or 5.25 percent of the domestic banking industry's total assets, the central bank said in a statement. In June 2007, the total assets of Islamic banks amounted to 29.2 trillion rupiah, or

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91 The three major Islamic banks in Indonesia are PT Bank Muamalat, PT Bank Syariah Mandiri, PT Bank Syariah Mega Indonesia.
92 http://www.hsbc.co.id/l/2/amanah_en_US/about-syariah-banking/the-industry
around 1.7 percent of the domestic industry's total assets, up from 1.55 percent at the end of 2006 and 1.42 percent at the end of 2005.\(^3\)

The only foreign bank currently licensed to conduct Islamic banking in Indonesia is HSBC, which offers Islamic banking services through its HSBC Amanah Syariah unit. In May 2007 the unit arranged a $50 million international sharia financing syndication for state-owned Krakatau Steel, Indonesia's biggest steel producer. That followed on two previous deals it arranged for state-owned oil-and-gas company Pertamina to tap the global Islamic finance market, including a $322 million Islamic international syndicated loan in 2004 and a similar $200 million deal in 2006.\(^4\) In June 2008, the House of Representatives has passed the Islamic banking law aimed at accelerating growth in the industry.\(^5\)

Abu Dhabi Islamic Bank (ADIB) has recently decided to enter the sharia banking business and announced its plan to acquire an Indonesian bank and transform it to a full sharia bank. Albaraka Banking group is also to expand its business in the country.

**Brunei**

The Asian Development Bank recently ranked Brunei as the richest economy in the Asian region. The sultanate's income per capita was recorded at US$ 34,629, more than 13 times the regional average of US$ 2,621. Of the total banks in Brunei Darussalam, Islamic Bank of Brunei Berhad (IBB) and Tabung Amanah Islam Brunei (TAIB) are the only banks that offer Islamic banking services. The others offer financial services based on conventional banking practices. It is only in the early 1990s that Islamic banking facilities were available. The first Islamic bank came into being with the inauguration of TAIB in 1992. TAIB's initial formation was as a trust fund whose prime function was to provide facilities for Muslims to make the pilgrimage to Mecca. The second

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\(^3\) *Reuters*, 31 July 07) [http://gifc.blogspot.com/search/label/Indonesia](http://gifc.blogspot.com/search/label/Indonesia).

\(^4\) [http://atimes.com/atimes/Southeast_Asia/IF26Ae01.html](http://atimes.com/atimes/Southeast_Asia/IF26Ae01.html)

Islamic Bank, the Islamic Bank of Brunei Berhad (IBB), was established as a fully-fledged Islamic Bank on the 13th January 1993 to provide people with Islamic banking facilities mainly in trade and commercial finance. IBB was a conventional conversion from the International Bank of Brunei Berhad. TAIB is similar to a savings and loan institution and is owned by the government. Its main objectives are to operate/promote Islamic financial services and to raise the socio-economic standards of the population.

The third one, the Islamic Development Bank Berhad (IDBB) (now merged with IBB) was initially set up as a conventional bank in March 1995. It was then known as the Development Bank of Brunei, a fully government owned banking institution. It started to operate on Islamic banking principles in 2000, and was renamed as The Islamic Development Bank Berhad (IDBB).

The most significant development of late for Islamic banking in Brunei is the merger of the Islamic Bank of Brunei (IBB) and the Brunei Islamic Development Bank (IDBB) on the 1st February 2006.

As a the end of the third quarter of 2007, Islamic banking in Brunei accounted for 39% of the total banking industry’s assets of BN$ 15.5 billion, 36% of the total banking deposits of US$ 12.1 billion and 51% of the total lending portfolio.

The Brunei government has taken an active role in promoting Islamic banking. One of the many schemes currently being undertaken is the development of a large Islamic capital market. A national shari‘ah financial supervisory board has been formed so as to help instill public confidence in issues in relation to shari‘ah compliant products marketed in or from this country.

The merger of IBB an Islamic Development Bank of Brunei Ltd on the 1st February 2006 marked another milestone in the development of Islamic banking in the country.
IBB, the leading Islamic bank in Brunei, registered a profit of BN$ 126 million for 2007, which is equivalent to 70% increase in profits compared to 2006.

In January 2008, IBB took a step towards the Ministry of Finance’s aspiration of developing Brunei into a reputable financial hub by launching a new addition of its existing divisions.

In conclusion, it can be said that Brunei Darussalam has seen tremendous change and improvement from practically zero Islamic banking to a feasible and practical approach in just over half a decade.96

Of late Islamic finance industry has received the attention of countries like Singapore, Philippines, Thailand etc. Singapore is taking keen interest in providing Islamic finance services and products. Many initiatives recently has been taken to try to make it a hub of Islamic finance in the region.

3.2.6 Islamic Banking in Middle East

United Arab Emirates

The United Arab Emirates (UAE) was founded in 1971 as a federal state comprising seven emirates (Abu Dhabi, Sharjah, Ajman, Fujairah, Umm al-Quwain and Ras al-Khaimah). The UAE is a major oil producer, and is the third-largest economy in the Middle East after Saudi Arabia and Egypt.

Muslim banking began in the UAE in 1975, when Dubai Islamic Bank was licensed to commence operations as the first public holding company conducting business governed by the precepts of shari‘ah.97 Nothing happened until Abu


97 Dubai Islamic Bank (DIB) was incorporated as a Public Joint Stock Company in 1975 as the first full-fledged Islamic bank. Since its formation in 1975 as the world’s first full-service Islamic bank, DIB has
Dhabi Islamic bank (ADIB)\textsuperscript{98} was established in 1997. Later on, Sharjah Islamic Bank\textsuperscript{99}, Emirates Islamic bank and Dubai Bank made their entrance in 2002, 2004 and 2007 respectively as a result of board decisions to convert those institutions from conventional to Islamic banks. More recently, Central Bank of the UAE has licensed Noor Islamic bank, al-Hilal Islamic bank and Ajman Islamic bank.

The Islamic finance industry in the UAE comprises eight full-fledged banking institutions, three Takaful companies, 11 Islamic finance companies and 14 Islamic banking divisions or windows of conventional banks. Then there are the national Bonds Company and two conventional finance companies offering Islamic finance products alongside conventional products. Many investors have set up their finance companies to be shari’ah compliant.

Islamic banking windows are a feature of Islamic finance in many countries. Fourteen conventional banks in the UAE offer Islamic retail, corporate and investment banking products through specialized division known as “windows”. However, most of the Islamic Finance companies and the Islamic banking windows are under establishment. Many banks in UAE have been selling their Islamic banking services under selected brand names such as Amanh, Badr al-Islami, Sadiq, Meathaq and Siraj.

National Bonds is the UAE shari’ah compliant saving scheme based on the Mudarabah structure. The organization is jointly owned by the government of United Arab Emirates.
Dubai, Dubai Holdings, Emmar properties and Dubai Bank. Its main mission is to raise *shari'ah* compliant finance.\(^{100}\)

Islamic banks in UAE have increased their share of total bank assets, from 8.8 percent at end-2002 to 12.6 percent at end-2006 (14.2 percent of deposits).\(^{101}\)

**Saudi Arabia**

Of late, Saudi Arabia has emerged as a major centre of Islamic Financial services industry. There is a growing demand in Saudi Arabia for banking products and services that comply with Islamic Shariah principles. This is recognised by the Saudi authorities who have encouraged Saudi banks to offer non-interest based banking products and services. Currently, all banks in Saudi Arabia offer Islamic banking services and their business in this area has grown rapidly.\(^{102}\) With the annual rate of growth between 15 and 20 per cent, the Saudi market for Islamic finance and banking is on course for phenomenal growth. Islamic banking has become the “norm” to a large segment of consumers, and an essential requirement for conducting business in the retail sector of the industry.\(^{103}\)

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\(^{102}\) Saudi Arab Monetary Agency (SAMA) http://www.sama-ksa.org/en/news/undated/special_feature.htm: “SAMA” was established in 1952. Its main role was to act as the central bank for the government. Its duties included –but not limited to-issuing the national currency (Saudi Riyal), supervising commercial banks, managing the country’s foreign exchange reserves, conducting the monetary policy and promoting the growth and soundness of the financial system. Constitutionally, *Shari’ah* supervision was not identified among its responsibilities. In 2003, Capital Markets Authority (CMA) was established to focus on the capital and investment markets so as to monitor publicly traded companies, ensure transparency, the regulation and development of issuing securities and protect investors from unfair market practices. But no *Shari’ah* supervisory responsibilities were assigned to the CMA.

\(^{103}\) A large number of bank clients in the kingdom demand Shariah-compliance in every aspect of banking and investments. Others prefer traditional banking and another segment resorts to traditional banking only in the absence of Islamic alternative.
In 1978, Al Rajhi Investment Co. in Saudi Arabia was set up as the first Islamic financial institution providing foreign exchange and money transfer services to a large segment of foreigners and locals in the country. In the late 1980s, the Islamic banking image appealed to other banks in Saudi Arabia such as the National Commercial Bank (NCB) but due to absence of structural clarity, it remained as an idea only. By the turn of the Millennium, Islamic banking has become an established form of banking in the Kingdom whereby two out of the ten local commercial banks are full-fledged Islamic bank. All others offer various Islamic banking solutions to their clients. At present, there are over 75 Shariah-compliant mutual funds offered by eleven local banks. Bank Al-Jazirah after having moved into the Shari'ah-compliant banking has registered outstanding growths in the past five years. It is the smallest bank in the kingdom, in terms of assets but it posted the highest growth in earnings, registering a 140% compound annual growth rate from 2002-06. Bank Al-Bilad, an initiative of the government

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104 Founded in 1957, Al-Rajhi Bank is one of the largest Islamic banks in the world with total assets of SR 124 billion (US$33 bn), a market capital of US$4 billion (www.alrajhibank.com.sa). As quoted by Wilson that in 1983, Al-Rajhi sought to convert to formal Islamic bank, consequently, a license was granted by SAMA on June 29 1987. (Rodney Wilson, Ahmed Al Rajhi, Monica Malik, & Abdullah Al Salamah (2004), ‘Economic Development in Saudi Arabia’, Routledge, p. 61; See also Jaffer, Sohail (2005), ‘Islamic Retail Banking and Finance: Global Challenges and Opportunities, Euromoney Books, p. 42.)

105 In 1985, Al-Rajhi Investment Co.—then still a foreign exchange provider—first introduced Islamic financing through Murabaha operations. The bank quickly gained reputation as a leading Islamic financial services provider in the kingdom. After posting remarkable gains in all aspects of its balance sheet throughout subsequent years, today it has become the largest Islamic bank in the world with a paid up capital of SR 13.5 billion and was rated “A” by Standard & Poors. According to the Banker report 2007, Al Rajhi is the largest Islamic lender in the world with assets of SR 105 (USD 28) billion. In February 2007, the bank officially launched banking operations in Malaysia. It is the first Saudi financial institution to operate in Malaysia. For latest data, See, http://www.alraihibank.com.sa/reports/Documents/Dec2007E.pdf.

106 In 1987, NCB (www.alahli.com) introduced its first Islamic mutual fund (International Trade Fund) based on Murabaha transactions and further aided by attractive interest rate levels at those times. In the mid 1990s NCB developed the first Shariah-compliance equity guidelines, a breakthrough that was later adopted and modified by Index providers abroad. During the period, NCB also launched the 1st Shariah-compliant global equity fund. In 2001, NCB launched Tayseer, a revolutionary Islamic financing tool that provides direct liquidity to loan takers in a Shari‘ah compliant mode based on Murabahah; NCB that was established in 1953 and went to the Islamic banking in 1990, had decided to convert to full-fledged Islamic banks in 2004, its total assets was (130.414 US$ billion in 2004 with 161 branch offering Islamic banking out of 248 total branches. (See, CIBAFI report (2005) p. 12.)


108 Founded in 1975, as the first joint venture between foreign and domestic shareholders, Al-Jazirah ran into financial trouble during the early 1990s. It has been back in profit since 1995, but its decision to convert to wholly shari‘ah compliant institution is now paying off. See the details: www.baj.com.sa
and SAMA, has also been successfully attracting the market as an Islamic finance player. When it floated half of its share, seeking to raise about $400m, the initial public offer (IPO) was five times oversubscribed, with nearly 9m Saudi citizens purchasing stock in the company.109

There are no restrictions on Saudi banks110 to choose any viable organizational model for carrying out such activities. These range from a bank that offers all its products and services on the basis of Islamic laws to others which provide these through selected branches, units, departments or through investment and mutual funds. Bank regulators do not undertake Shariah-related duties. Each institution is free to recognize its Shariah criteria, Shariah board and acceptable established practices.111 However, all eleven local banks have their own Shariah boards with some chief Shari'ah experts sitting on the Shariah boards of several banks.112

Some reports say113 that Islamic financial services continue to grow faster than conventional banking in Saudi Arabia. The popularity of Islamic banking can be gauged by the increasing share of Islamic assets even within conventional banks. To date, three banks namely, Al-Rajhi, Bank Al-Bilad and Bank Al-

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109 The Report Emerging Saudi Arabia 2007, Published by Oxford Business Group, pp. 84-85
111 Saudi Arab Monetary Agency (SAMA) [http://www.sama-ksa.org/en/news/undated/special_feature.htm](http://www.sama-ksa.org/en/news/undated/special_feature.htm): While recognizing the special characteristics of Islamic banking activities, the supervision and regulation SAMA exercise are consistent with those for normal commercial banking. Consequently, capital adequacy, liquidity and other supervisory requirements are applied to these activities. SAMA also practices both on-site and off-site supervision and requires banks to report these activities through special prudential returns. It is important that strong corporate governance standards are applied by all banks offering these products and that the risks related to Islamic banking are identified, reported and managed by the banks. Of late, SAMA has also participated along with some other Islamic countries in forming the Islamic Financial Services Board (IFSB), which has the development of supervision standards and practices for Islamic banks and products and services as its objectives (to promote Islamic banking and finance and enhance its credibility and stability).
112 Currently, the selection of Shariah specialists who meet certain bank criteria is conducted through direct appointment or nomination by the management board.
Jazeerah are fully providing shari'ah compliant facilities i.e. 100% whereas others viz, Saudi Arabian Agricultural Bank (SAAB), NCB, Riyadh Bank, The Saudi American Bank (SAMBA), Saudi Hollandi Banks, Banque Saudi Fransi, Saudi Investment Bank (SIB) etc are partly offering this facility i.e. 51%, 45%, 38%, 33%, 20%, 19% respectively. Major Saudi corporates are increasingly turning to Islamic structures to raise financing. For example, SABIC (Saudi Arabian Basic industries Corporation) raised over US$ 2 billion through Sukuk Issue & US$ 10 billion Murabaha through Deutsche Bank and Dar Al Arkan, over US$ 1 billion raised through Sukuk & US$ 400 million raised through Islamic debt and whereas others Saudi Aramco, GAS, Al Gosaibi, SCC (Specialized Contracting Company) and Savola have all accessed the Islamic finance market. Expected rate of growth of Islamic banks are estimated to be 20%-30%. Thus, the last few years have witnessed a significant change in the Islamic banking industry in Saudi Arabia, with new products following increased demand. In terms of the takaful market, there has been an effort to liberalize the market by the government, with many analysts expecting the market to grow to $8bln within 10 years, from $1bln at current levels.

One of the most significant contributions of Saudi government to Islamic finance is its sponsorship of the Islamic Development Bank (IDB).

Qatar

The first initiative in the country was taken in early eighties with the establishment of Qatar Islamic Bank (QIB) in 1982 which followed by the opening of Shari'ah Compliant Facilities as % of Total Loans and Advances -2006. (Source: Standard and Poor’s, Global Research) http://www.kifsaudi.com/en/contents/presentations/3_KIF_sameer_ErnstYoung.pdf. For detailed analysis, See, Andrew Cunningham (2007), ‘How Big Is “Islamic Banking”? – A Snapshot From Saudi Arabia’, Middle East Economic Survey, VOL. L, No 41, 08-October; http://www.mees.com/postedarticles/oped/v50n41-5OD01.htm

see for details; The Report Emerging Saudi Arabia 2007 op. cit; pp. 81-83

ibid.

http://www.islamicbanker.com/databasesaudiarabia.htm

Islamic Development Bank (IDB) is a multilateral development financing institution, established to foster social and economic development of its member countries and Muslim communities world-wide.
of Qatar International Islamic Bank (QIIB) in 1991. QIB was incorporated as a shareholding company to provide Sharia'h compliant banking products and services and it current ranks among the world’s five largest Islamic Financial Institutions (IFIs). It has international investment operations in Asia, the Middle East, Europe, & North Africa (Malaysia, Bahrain, Lebanon, the UK and Yemen). As for the QIIB, since opening its doors on January 1, 1991, it has rapidly grown to become one of the healthiest and most successful banks in Qatar in terms of growth and profitability. During the years 1992 through 2000, it achieved average annual assets growth rate of 25%, average annual local investments growth rate of 30%, average deposits growth rate of 20%, average profit growth rate of 28% and average efficiency rate among the top three Qatari banks.

The face of Islamic banking in Qatar changed drastically in 2005 and 2006 as services available to the market have gone from the actual services (being provided QIB & QIIB), to a range of products offered by conventional banks. As its core, the industry has always been based on the principles and preferences of its customers, whose desire for shariah-compliant products has benefited from the accelerating growth in awareness over the past 25 years. In 2004, the central bank of the country passed the regulations, following which four biggest commercial banks started offering Islamic products. An Islamic finance house, Qatar First Finance, launched an initial public offering (IPO) on the Doha Securities Market (DSM) in 2005. Additionally, a brand new, full service bank, Masraf al-Rayan, raised QR 3.75 bn ($1.03 bn) in an IPO in 2006, with extensive participation from GCC investors. These prominent developments have further driven awareness and demand for Shariah-compliant institutions.

Conventional banks have taken a number of approaches to establishing Islamic subsidiaries, a trend started in 2005. National Bank (QNB), Doha Bank

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119 QIB was upgraded to a rating of A- by Standard & Poor during the last quarter of 2006, based on its outstanding financial position. It was also rated by the London based Islamic Conference Group as the best finance house in Qatar in real estate financing.
and Ahli bank each set up Islamic banking windows within their conventional operations, while the country’s second largest banking institution, Commercial bank, established a subsidiary, Al Safa Islamic Banking (its operation commenced in 2005) is rapidly expanding with the income growing by 472% to QR 50m ($13.75m) in 2006. Following the initial launch of retail banking activities, Al-Safa has begun to offer corporate and investment banking services. Thus, the Islamic banks there got involved in both retail and investment banking (including corporate one) as well along shariah principles. Masraf Al-Rayyan and QIB both registered investment banking subsidiaries with the Qatar Financial Centre (QFC) in mid-2007. All of the Islamic banking subsidiaries have ambitions along these lines. Initially, they first focused on retail banking side, then gradually moved into corporate and investment financing. The further ambition of Qatari Islamic banks is to become global competitors by establishing subsidiaries abroad. Standard & Poor’s (S&P) has estimated the potential demand for Islamic finance to be 10 times higher than today’s outstanding $400 bn global asset base. QNB, which has around 40% market share of overall commercial banking sector assets, moved into Islamic finance in 2005 by offering promotions to clients to switch to Islamic deposits accounts at its main Islamic division, QNB al-Islami. It thereby increased its market share in Islamic deposits to 24% or $1.51bn in less than two years, but it hold only $550m in loans, 13% of the Islamic market. In addition, Doha Bank’s Islamic services has had greater than average success in expanding its loan portfolio, which hit $275m in 2006, for a loan-to-deposit ratio of 124%. Masraf Al Rayyan, on the other hand, established itself on a broader capital foundation than the market leader, QIB, with $2.06 bn in authorized capital, of which roughly half is paid in. In a soft launch over the course of 2006, the bank only reached $51.15m in loans and made a net profit of $30.8m. Boosting overall liquidity and improving asset management services have become much easier for Islamic banks since the central bank unified the Islamic financial sector’s regulation under completely separate code than the conventional banking sector. Thus Qatar is gaining more
momentum as growing market in Islamic finance sector. It will gain increasing credibility in the coming years as a lead player in Islamic finance.

Takaful or shariah-compliant insurance, has gained a strong edge in the country. Qatar Islamic Insurance Company (QIIC), operational for a little more than a decade, has taken a long lead in takaful. Its gross premiums increased from $30.53m to $42.08m in 2006. QIIC has leveraged its success in Qatar with subsidiaries in two international markets. At the end of 2006, it announced the Pak-Qatar Family Takaful companies with paid up capital of $10.73m. It also got approval from a Syrian regulator to open Syrian-Qatar Takaful Company.\(^{120}\)

**Bahrain**

Bahrain is one of the most key players in Gulf region. It established its high status in global Islamic Banking Industry and entrenched itself as a global hub for Islamic finance. It has played key role in establishing various international institutions for the development of Islamic finance.

The birth of Islamic banking services in Bahrain dates back to 1978 when Bahrain Islamic Bank was established to provide commercial banking services. Islamic banking in Bahrain gained momentum in the early 1980s, with the issue of four new licences, one of which was an offshore banking unit license, while the rest were investment banking licences. The 1990s marked a turning point in the development of Islamic banks in Bahrain. The Bahrain Monetary Agency (BMA), during the 1990's, issued a total of eight licenses to a diverse group of institutions to enable them to pursue Islamic banking services. Bahrain pursues a dual banking system, where Islamic banks operate side by side with their conventional counterparts.

Kuwait is the old player in Islamic banking industry. The first initiative was taken with the establishment of Kuwait Finance House in 1977. It has proved its

\(^{120}\) *The Report Emerging Qatar 2007*, Published by Oxford Business Group, vol. 4, pp. 91-96, August 14.
successful operation in the region and appeared as a model for others to follow the
suit. Likewise other countries in the Middle-East such as Lebanon, Jordan, Turkey
Syria, and Yemen have taken many initiatives in providing Shari‘ah compliant
services and established full-fledged Islamic banks.

In Africa, Islamic finance industry is not alien rather recognized since long.
Various parts of the continent took lead to take initiative in introducing Islamic
banking industry. Sudan tried to islamize its entire financial system. Whereas
Egypt is believed to be the birthplace of Islamic banking. Of late, Kenya, Nigeria
and other countries has taken initiative to enter Islamic finance industry with the
establishment of full-fledged Islamic banks and Islamic banking divisions. Kenya
and Syria have opened two Islamic commercial banks.

Aside from the fact stated above, the key areas of growth with respect to
geographical distribution of new Islamic banks in 2007 include the UK, with at
least five new investments banks offering mostly Islamic investment and treasury
banking services; France, where a license has been applied for the first Islamic
commercial banks; and finally, Germany is listed as a potential base for new
Islamic banks. Italy, Australia and New Zealand are also taking interest in
providing Islamic financial products. GCC based Islamic banks have also begun
venturing into European countries.

From the following figure, we may observe that although IFSI is distributed
all over the world continents, its largest geographical intensity in our days is in
Middle- East regions including GCC with a proportion of (53%), followed by
Indian sub-continent, South-East Asia, Africa and the rest of the world with a
share of 16%, 13%, 9%, and 9% respectively.
3.2.7 Islamic Banking Practices by Western Financial Institutions:

The development of Islamic finance has been helped too by the interest of western banks such as ANZ Grindlays, Chase, Citicorp, HSBC and Morgan Stanley have introduced Shariah compliant products and services. The importance of Islamic banking is also evident by the decision of major stock exchanges such as the Dow Jones and FTSE to offer Islamic indices.

In the United States, the first Vice President of the Federal Reserve Bank calls that “Islamic bankers have been quite ingenious in developing financial transactions that suit their needs: we bank supervisors, too, can be ingenious and will want to work with any of you should you decide that you want to engage in
Islamic banking in the United States. That is not to say that all issues can be resolved to your satisfaction. But our doors are open; indeed”.121

Most of the large Western financial institutions, following the example of Citibank, have their own Islamic subsidiaries or, at the very least, Islamic banking "windows" or products aimed at their Islamic clientele. There is even a Dow Jones Islamic market index.

Professor Rodney Wilson aptly remarked, “It is an excellent reflection of the success of Islamic banking that many conventional commercial banks are now offering their clients Islamic financial services”.122 In USA several groups of bankers are practicing Islamic system with a better result. Concerning the application of Islamic banking principles in America, Ken in his article Islamic banking: faith and creativity, notes ‘Islamic banking is making inroads in America as several groups of bankers and Muslim scholars attempt to create an interest-free banking system that uses lease agreements, mutual funds, and other methods to avoid interest payments’.123

HSBC has launched its HSBC Amanah Finance division, focusing on Islamic financial products. There are also western based, but exclusively Muslim financial institutions such as the United Kingdom based, Ummah Finance Group, which offers an Islamic Unit Trust and the Kleinworth Benson Islamic Unit Trust which is based in Jersey124. Murabahah or cost-plus financing transactions have earned Kleinworth Benson $ 4 billion in 1992, while ANZ Grindlays earned $400 million. The banks arrange for transactions within the limits set by the Islamic


banks and get it approved by the Shariah advisors of investors or by banks engaged in the transactions.¹²⁵

These institutions have mostly adopted the pattern of Islamic banking in cost-plus financing, leasing and equity financing for their clients in the Middle East, Southeast Asia and a few international corporations in Europe and Latin America. However, some of the Islamic economists are apprehensive about sincerity of these multinational financial institutions as far the commitment towards the cause is concern. Three senior economists at IDB including the chief of research division at IRTI are of the view that the modus operandi of these institutions is purely commercial. They are of the opinion that these conventional banks may not follow correctly and faithfully the percepts of Islamic banking. “In all major Islamic banks, there is a Shariah board, which regularly reviews the operations and contract of the bank to determine their compliance with the requirements of the Shariah. Similar arrangements do not exist at the conventional Western banks in most of the cases. It is also suspected that conventional banks may not be able to keep fully separate accounts for their Islamic banking operations. In the event they do mix “Islamic money” with their general pool of investible resources or they do not keep separate accounts for Islamic banking activities, there is a strong possibility that permissible returns may be ‘contaminated’ by riba”.¹²⁶

3.3 Conclusion:

Islamic banking practice started with the establishment of Mit Ghamr in 1963 has shown tremendous growth and potentials since then. Research works have shown that Islamic banking principles are not only viable but also more efficient and stable than their counterpart conventional banks due to their participatory nature. Islamic banking has established itself as an emerging

¹²⁵ Parker, M., ‘Getting the message across: Islamic banking gets recognized by the Western banks’, The Middle East, October, 1993 no., 227, p. 28.
alternative to interest-based banking and is gaining roots in both Muslim as well as non-Muslim countries.

Several observations of the various international bodies like, World Bank, International Monetary Fund (IMF), International Finance Corporation (IFC), Organization of Economic Cooperation and Development (OECD) have advocated the possibility and viability of the equity based and participating and investment policy of Islamic banks.

In the World Development report 1989 the Islamic banking system is highlighted as under; "Islamic banks offer savers risky open-ended mutual fund certificates instead of fixed-interest deposits. This is not unlike cooperative banks and mutual funds in the west, where deposits earn variable interest and double as equity. Difficulties arise on the lending side. Arrangements to share profits and losses lead to considerable problems of monitoring and control, especially in lending to small business".\(^{127}\)

By 2005, according to the International Monetary Fund (IMF) yearly report, over 300 Islamic financial institutions were operating worldwide, with estimated total assets of US$ 250 billion and annual growth rate of 15%.

The *Euromoney Islamic Finance Review* for 2007/08 stated that the estimated Islamic financial market size was US$ 700 billion to US$ 750 billion, with an annual growth rate of 15%. It has been reported that the Islamic banking industry is growing at 20% per year and will reach a level with total assets exceeding US$ 1 trillion by 2016.\(^{128}\)

According to McKinsey report, current global Islamic banking assets and assets under management have reached USD750 billion and is expected to hit

\(^{127}\) *World Development Report, 1989*, Box 6.3

\(^{128}\) *Islamic Finance News Guide 2008*, p. 59
USD1 trillion by 2010. There are over 300 Islamic financial institutions worldwide across 75 countries according to the Asian Banker Research Group. The World's 100 largest Islamic banks have set an annual asset growth rate of 26.7% and the global Islamic Finance industry is experiencing average growth of 15-20% annually.

Saleh Kamil, the chairman of the General Council for Islamic Banks and Financial Institution (GCIBAFI) believes that the Islamic banking industry is growing at 35 percent a year, with assets of financial institutions reaching $600 billion in 2007. Kamil counts the number of Islamic banks in 2007 to have been 470, up from less than 300 in 2005.

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130 ibid  
131 ibid  
132 New Horizon, News section, "How quickly can the Islamic finance industry grow?, July-Sept. 2008
CHAPTER IV

CONCEPT OF MURABAHAH
CONCEPT OF MURABAHAH

4.1 Introduction:

Most of the Islamic banks and financial institutions are practicing "Murabahah" as an Islamic mode of financing that ranks highest in use, the majority of the financing operation carried out by them is based on this technique. They use the concept of Murabahah sale to satisfy the requirements of various types of financing, such as financing of raw materials, machinery, equipment and consumer durables as well as short-term trade financing etc. For this reason, this term is appreciated as a method of banking operations, whereas the original concept of "Murabahah" is different.

4.2 Meaning Of Murabahah:

Lexical: "Murabahah" an Arabic word has been derived from the root "r-b-h" ربح meaning profit, gain or addition.¹

Legal: Murabahah is legally a particular sale of trust in which a commodity is sold at the original purchase price plus an agreed upon marked up profit. Alternatively it can be described as "a sale transaction on a cost-plus-profit basis".²

4.3 Murabahah as defined by Classical Jurists:

1. Hanafi School:

Imam al-Kasani said: "Murabahah is a sale with the same (original) purchase price plus an amount of additional profit."³

¹ Ibn Manzoor, "Lisan al-Arab", published by Dar Sadir Bainut, vol. 2 p. 442
² Thanvi, Muhamad Ala b. Ali, "Mausoo'ah Istilahat al-uloom al-Islamiyah, also known as 'Kashf Istilahat al-Funoon' vol. 2 p. 538; Usmani, Muhammad Taqi (2005), ‘An Introducion to Islamic Finance’. Idara Isha’at-e Diniyat (P) Ltd., p. 96
³ Al-Kasani, "Bada’i al- Sana’i", vol. 2, p. 538
Abdullah b. Mahmood al-Moosali said: “Murabahah is resale with a stated surcharge (add-on profit).”

Al Marghinani defines Murabaha as “the sale of anything for the price at which it was purchased by the seller and an addition of a fixed sum by way of profit.”

2. Maliki School:

“Murabahah is a sale with the original purchase price and a declared extra amount of profit mutually agreed upon.”

Ibn Rushd says: “There is consensus among the majority of jurists upon that the sale is of two type: Murabahah & Musawamah; In Murabahah, the seller would disclose to the buyer the price he originally paid for the goods and state a surcharge in the form of dinar or dirham as condition that represents profit.”

Ibn Jazzi defined Murabahah that the seller would mention of how much he originally paid for the goods and what profit he would charge either in aggregate, (e.g. he would say that he purchased it for ten and would charge profit of one dinar or two dinar.) or in detailed statement, i.e. he would say to have the profit of one dirham for each dinar etc.

3. Shafi‘ee School:

Sheerazi said: The seller would clearly state the original cost of the commodity (ras al-mal) and the rate of profit as he would say that its purchase

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price is 100 *dinar* and I sell it to you with its original price and a profit of one dirham in each ten (that is charging the ten percent profit).\(^9\)

Ibn Hajr al-Haytami said: Murabahah is the profit i.e. an addition over the cost.

4. *Hanbali School:*

Ibn Qudamah has defined Murabaha as: “A sale of a commodity with its original cost plus a stated profit. The knowledge of capital cost (*ras al-mal*) is a precondition in it. Thus the seller should say: ‘My Capital involved in this deal is so much or this thing has cost me (Dirham) 100 and I sell it to you for this cost plus a profit of (Dm) 10.”\(^10\)

**Summation of the opinions:**

Having gone through these definitions, we conclude the followings:

1. Disclosure of the original price and the cost incurred.
2. The surcharge, extra amount of profit must be known and mutually agreed upon.

Thus, the definition is based on three major elements; they are:

a) The commodity should be owned by the seller with possession that covers all the rights, liabilities and responsibilities pertaining to the commodity including the risk of loss, damage or its destruction.

b) Clear statement of both the price and the cost that the seller has originally paid for the commodity.

c) A stated agreed upon margin of added profit.

Thus, by definition, it is basic for Murabahah that the buyer must know the original price, additional expenses if any and the amount of profit. Accordingly, it is a contract of trustworthiness.

4.4 Forms of Murabahah:

Classical jurists have mentioned different forms of Murabahah.

1. Saying of the seller: This commodity costs (Dinar) 100 and I add 10, as a profit thereupon. Be it known that the commodity is present at the time of sale contract. There is no divergence of opinion among the jurists upon this.

2. Another statement of the seller: I sell you the commodity with its capital cost of dinar 100 (ras-al mal), charging one dirham in each ten i.e. ten percent profit. The majority of the jurists have approved this form whereas some others have shown disapproval like Imam Ahmad, Ishaq b. Rahwaihe etc. As It has been narrated that Ibn Mas'ud (mAbpwh) ruled that there was no harm in declared lump-sum or percentage profit margins.

3. The commodity might not be present at the time of contract; the purchaser asks the seller to buy the specific commodity and he would purchase it with its purchase price plus a stated surcharge. This is called “Bay al-Murabahah li al-amir bi al-Shira” (Murabahah on purchase order). This form of Murabahah has been widely used and practiced by contemporary Islamic Banks and Financial Institutions.

Some relevant text may be found in “Kitab-al Umm” of Imam Al-Shafaee to deduce the conclusion that this specific form of Murabahah is not against the Shariah principles and thus corroborating its legitimacy. This issue will be later discussed in detail.

However, being practiced dominantly by modern Islamic financial institutions, it has aroused a great deal of legal (fiqhi) discussion by contemporary Jurists.

During the last two decades, a number of researches papers and books have been written that deals in detail the legal discussion of this specific form of Murabahah covering its various aspects.  

4.5 The Rationale for Murabahah:

Murabahah sale performs a useful function in the sense that it provides a valuable service in economic markets since it allows those knowledgeable of market conditions to make a profit and those without such knowledge to obtain the goods at a good price. Thus, "Murabahah is a form of commission sale, where a buyer who is usually unable to obtain the commodity he requires except through a middleman, or is not interested in the difficulties of obtaining it by himself, seeks the services of that middle man." 

What must further be added, however, is the element of trust. The middleman performs a dual service, he facilitate the financing of a deal, and he does so in such a manner that even the most naive of consumers may rest easy with regard to the value he is receiving for his money.

De Lorenzo, Y. T. contends here thus:

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13 Professor Udovitch goes on to say, "Al-Marghinani suggests that their [sales of trust] purpose, particularly of the tawliyah and murabaha sales, was the protection of innocent general consumer lacking expertise in the various items of trade from the wiles and stratagems of sharp traders." Op. Cit. p.220

“This last point is an intriguing one, and one that deserves further consideration. The classical jurists were careful to trace every transaction they described and regulated to a clearly Islamic origin, thereby to establish the transaction as one that had the approval of the Almighty. Thus the manuals of *fiqh* and their glosses are sure to begin their discussions of every new form of transaction by establishing Islamic authenticity, or justifying licitness or otherwise, through reference to the *Qur’an*, the *Sunnah*, consensus of the community, and/or the practice of the caliphs or early Companions. In a very few cases, however, the only sort of recourse available was to the practical grounds of its economic function in society. Apparently, and despite the best efforts of the jurists find a more sacred source for it, *murabaha* falls under this category.”

4.6 Legitimacy of *Murabahah*:

*Murabahah* is a legally permissible contract by the testimony of the majority of jurists. However, the legal evidences or indicators variously adduced by the classical jurists for the legitimacy of *Murabahah* contract are mainly general in nature and not at all specific to *Murabahah*. The proof of its permissibility is derived from the following:

1. There are many verses in the *Qur’an* that explicitly permit sales in general, e.g. “And Allah has permitted trade” [2:275], “But let there be among you traffic and trade by mutual good will” [4:29]. In this regard, *Murabahah* sales are clearly concluded by mutual consent.

“And when the prayer is ended, disperse freely on earth and seek to obtain [something] of Allah’s bounty” (62:10). This verse cited as evidence for the legitimacy of *Murabahah* is found in majority of the *fiqh* manuals. In a very general manner, the said verse establishes that it is lawful for people to go out in the world and earn their living. Such generalized permission may suffice as proof

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15 De Lorenzo, Y.T., “*Murabaha, Sales of trust, and the Money value of time*”, op. cit. p. 147

16 De Lorenzo, Y.T., op. cit, p.147
that trade and commerce are sanctioned by the Almighty; but there is clearly nothing in the verse about Murabahah. The same is true of other verses cited by the jurists in support of this transaction. For instance,

“He it is who has made the earth easy to live upon: go about, then, in all its regions, and partake of the sustenance that He provides” (67:15).

2. A valid narration reports that the Prophet (pbuh) while planning for emigration to Madinah, learned that “Abu Bakr had purchased two camels. He asked him to sell him one at the price at which he obtained it “wallini ahadahunna”.

Abu Bakr said: “It is yours at no price”, but the Prophet (pbuh) replied: “Not without a price”.17

3. This type of sale satisfies all the legal requirements for sale.

There are many hadith put forth by fuqaha for the permissibility of Murabahah such as the Hadith related by Tabarani: Seeking the lawful is the duty of every Muslimi. Or the Hadith related by Muslim, Abu Dawud, Tirmidhi, Nasa‘i and Ibn Majah: If the two [counter values] are of different kinds, then sell as you like, provided that the deal is hand to hand. Or finally the Hadith related by Ibn Hibban and Ibn Majah: Varily, a sale is what takes place when there is mutual agreement.

Saeed Abdullah while investigating the specific references to murabahah permissibility concludes as:18

“The Qur'an, however, does not make any direct reference to murabahah, though there are several references therein to sale, profit, loss and trade. Similarly, there is apparently no hadith which has a direct reference to murabahah. Early

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17 Narrated by Al-Bukhari on the authority of Ayesha (mAbpwh) and also by Imam Ahmad in his Musnad, Ibn Sa‘d in Al-Tabaqat, and Ibn Ishaq in Al-Sira.
scholars like Malik and Shafi'i who specifically said that a *murabahah* sale was lawful, did not support their view with any *hadith*. Al-Kaff, a contemporary critic of *murabahah*, concluded that *murabahah* was “one of those sales which were not known during the era of the Prophet (peace be upon him) or his companions.”\(^{[19]}\) According to him, prominent scholars began to express their view on *murabahah* in the first quarter of the second century AH, or even later.\(^{[20]}\) Since there is apparently no direct reference to it either in the *Qur’an* or in the generally accepted sound *hadith*, jurists had to justify *murabahah* on other grounds.\(^{[21]}\)

Yusuf Talal DeLorenzo, a Shariah consultant and Islamic financial advisor to the Dow Jones Islamic Market Index (New York) has rightly pointed out\(^{[22]}\) that the verses and *Hadith* literature presented by the jurist for the permissibility of Murabahah sale are not specific and inclusive rather unclear and imprecise. He further comments:

Several of the jurists appealed to *ijma’* as the justifying factor.\(^{[23]}\) An interesting twist to the same was claimed by Badr al Din al ‘Ayni, in his commentary on *al Hidayah*, in which he explained that Murabahah is lawful:

“...because the item for sale is known, and so is the price. People deal in it without anyone’s objecting to it. And when people deal in something without objecting to it, that is proof in itself of its validity because the prophet, upon him


\(^{[20]}\) Malik supported its validity by reference to the practice of the people of Madina: “There is consensus of opinion here (in Madina) on the lawfulness of a person’s purchasing cloth in a town, and taking it to another town for selling it on the basis of an agreed upon profit.” (al-Kaff; pp. 5-6). Whereas Shafi’i without justifying his view by any shari‘ah text, said: “If a person shows a commodity to person and says, ‘Purchase it for me, and I will give you such and such profit, and the person purchase it, the transaction is lawful.” (Shafi’i, *al-Umm*, vol. III, p. 33) The Hanafi jurist, Marghinani (d.593/1197), justified it on the ground that the conditions essential to the validity of a sale exist in it, and also because mankind stands in need of it.” (Marghinani, *Hedayat*, or *Guide*, p. 282); The Shafi’i jurist, Nawawi (d. 676/1277) simply said: “*Murabahah* sale is lawful without any repugnance.” (Nawawi, *Rawdat al-Talibin*, p. 526) see for the right references Saeed Abdullah, *Islamic Banking & Interest*, p. 77 as these references have been cited by him.

\(^{[22]}\) De Lorenzo, Yusuf Talal, op. cit. p.148


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be peace, said, ‘what is considered becoming by the Muslims is considered
becoming by Allah.”^24

In the Classical Islamic hierarchy of evidence, the indicators, adillah, from
the Qur’an, the Sunnah and the ijma’ are the ones that carry the most weight. It
should be clear from the foregoing, however, that the proofs adduced from those
resources are hardly specific to murabah, and thus quite open to challenge. Clearly
the jurists had to rely on other evidence from other sources in order to establish the
lawfulness of this particular transaction. In other words, while the jurists did cite
evidence from the Qur’an and the sunnah in support of Murabahah, the evidence it
self is in no way specific to Murabahah. Moreover, no specific mention of the
transaction is to be found in even the weaker Hadith literature. In other words, the
most pertinent and substantial indicators for the legitimacy of the Murabahah
transaction are the ones accorded the least weight of all by the jurists.^25

Dr. Yusuf al-Qaradawi, an eminent contemporary shari’ah expert contends that:

“The majority of scholars permit it [Murabahah] because the basic principle
is the permissibility of things, and no clear text exists prohibiting such a
transaction.

Furthermore there is no resemblance to interest in such a transaction, since
the seller is free to increase the price as he deems proper, as long as it is not to the
extent of blatant exploitation or clear injustice,...“^26

4.6.1 Other Considerations in the Legitimacy of Murabahah:

Burhan al Din al Marginhani (d. 593 AH), in his work al Hidayah fi Sharh
al bidayah^27, first has taken help to legal principle when explaining the legitimacy
of Murabahah: “It is lawful owing to its meeting all the conditions for validity,”

25 De Lorenzo, Y. T., op. cit. p.148
26 El-Helbawy, Kamal et al, tr. Al-Qaradawi, Yusuf, ‘The lawful and prohibited in
Islam’ (Indianapolis: American Trust Publications, undated), pp. 269-70
27 The mainstay of latter Hanafi fiqh scholarship.
(ja’iz li istijma’i shara’it al jawaz). Thereafter, his commentator, Ibn al Humam noted,

“Since more than just the meeting of conditions is required to establish legitimacy, the author further mentioned the occasioning factor by saying, ‘There is a great need for this sort of dealing because one inexperienced in the ways of business will have to depend on those more experienced, and be satisfied with paying as much as the more experienced one has paid, plus an additional amount of profit. This is why it is essential to term these sales lawful.’ It should be clear that there is no need for proof of their legitimacy beyond the proof establishing the legitimacy of sales in general when there is mutual agreement and there is nothing to interfere with the conditions for a valid sale. Rather, the proof of the legitimacy of sales in general is the proof of the legitimacy of Murabahah and tawliyah.”

To explain the issue under discussion, De Lorenzo, Y. T. comments as follows:

Here, what the commentator means when he refers to “meeting the condition” is that it is not enough for a transaction to fulfill the prescribed legal formula of there being a buyer, a seller, an object of sale, an offer by the seller, and an acceptance by the buyer. These are the elements of a transaction deemed essential by the classical jurists. However, just because these elements are present, it does not automatically follow that the transaction will be lawful.

In addition, then, al Marghinani had to offer more convincing evidence for the legitimacy of this particular transaction, Murabahah. That is why he mentioned the occasioning factor, or illa. The classical jurists explained that while there are no occasioning factors in matters related to worship, ibadat, because these are related to the inscrutable will of the Almighty, there are always

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29 He contended that the purpose of Murabaha (and Tawliyah) is the protection of innocent consumers lacking expertise in trade from the tricks and stratagems of cunning traders. (See al-Marghinani, 1957, p.282, as cited by Ayub.M.,(2007) *Understanding Islamic Finance*, p. 216)
to the worldly interests of humans occasioning factors in transactions, *mu'amalat*, because these are related to the worldly interest of humans.³⁰ They further explained that the benefit of occasioning factors is that they facilitate an understanding of Shariah rulings and categorizations by clarifying cause and effect relationships in the law. If a feature can be shown to constitute the occasioning factors behind a ruling in a principal case, then it becomes relatively easy to establish the same ruling in a novel case with the same feature.

What al Marghinani and his commentators, both Ibn Humam and Badr al Din al ‘Ayni, appear to be attempting, however, is to provide a rationale for the transaction, thereby establishing its ethical and Islamic legitimacy.³¹ Not all jurists, however, held that a rationale, or *hikmah*, could function as an ‘*illah* or occasioning factor.³²

He then concludes that it can be deduced that Murabahah, in its protecting the innocent consumer, actually assigns a money value of trust rather than to time. There is a value to knowing and to being able to trust that knowledge. Thus from this perspective, Murabahah holds nothing that could be considered grounds for prohibition or legal disapproval, *Karahah*. When dealing with the challenges of modern financial practice, it may be noted that consideration of such factors may well entail a new understanding for the *Shariah*.

Thus, a person who lacks skill in making purchases in the market on the basis of *Musawamah* is obliged to have recourse to a Murabahah dealer who is known for his honesty in this particular type of trade, and thus purchases the article from that person by paying him an agreed addition over the original purchase price. This leaves the actual buyer satisfied and secure from the fraud to which he was exposed for want of skill. Hence, it is evident that the main purpose

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³⁰ *Kuwait Fiqh Encyclopedia*, vol. 12, p. 319
³¹ De Lorenzo, Y. T., *op. cit.* p. 148
of this form of *bai* is to protect innocent purchasers from exploitation by cunning traders.

Udovitch suggests that *murabahah* is a form of commission sale, where a buyer who is usually unable to obtain the commodity he requires except through a middleman, or is not interested in the difficulties of obtaining it by himself, seeks the services of that middleman.\(^{33}\)

### 4.7 Musawamah Sale:

If the cost of the article sold is not disclosed to the buyer at the time of selling, it is called a Musawamah sale (i.e. sales based on negotiation).\(^{34}\) Here the sale takes place on a lump-sum price basis, without the contract having any mention of the cost and profit components. The buyer accepts to buy the article at the lump-sum price agreed, irrespective of the amount of profit earned by the seller through the sale. Mostly, sales take place on the basis of Musawamah, such as when purchasing a commodity from a shop without any enquiry as to what the cost of the item was.

For example, in selling a computer, if A tells B “I have sold this computer to you for USD 1000” without any mention of the cost incurred by him, it is a Musawamah sale.

It should be noted that the buyer happening to be aware of the cost of the item alone will not convert the sale into a Murabahah, as long as the contract of sale does not indicate the cost, relating it to the price.

Thus, the only feature distinguishing a Murabahah sale from other kinds of sale is that the seller in Murabahah expressly tells the purchaser how much cost he has incurred and how much profit he is going to charge in addition to the cost.

\(^{33}\) Udovitch, p. 221

\(^{34}\) Usmani, M.T. op. cit; p. 96
Here it is interesting to note that Imam Ahmad prefers ordinary sale (musawamah) over Murabahah in the following words:

“To me, Musawamah is easier than Murabahah, because Murabahah implies a trust (reposed in the seller) and seeking of ease on behalf of the buyer, and it also requires detailed description to the buyer, there is very likelihood that selfishness may overcome the seller, persuading him to give a false statement or that mistake may occur which makes it exploitation and fraud. Avoidance of such a situation is, therefore, much better and preferable”.

The same ideas have been expressed by a Jafari jurist on the authority of Imam Husain. After basing the sale price on the original cost of the goods to the seller, the purchaser is provided with a modicum against unjust exploitation by unscrupulous merchants.

It is important to observe, however, that modern Murabahah is conducted mainly by banks and financial institutions on a deferred payment basis. Upon execution of Murabahah, a receivable is created that becomes the liability of the customer. The aspect of disclosing details of the banks’ cost price, though a necessary condition of Murabahah, does not remain a serious issue between the parties, particularly in view of the fact that the customer himself is involved one way or the other in locating and purchasing the goods.

4.8 Basic Features of Murabahah Sale:

As pointed above that being a particular kind of sale, Murabahah is different from the common sale (Musawamah), therefore, it has some specific characteristics and conditions that are not related to others. In Murabahah, the profit may be determined by mutual consent, either in lump sum or through an agreed ratio of profit to be charged over the cost. All the expenses incurred by the

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35 Al-Kulayani, 1278 AH, p.197 as cited by Ayub, op.cit, p.216
36 Uovoitch, (1970) op. cit; p.220
37 Ayub, Muhammad G. (2007), Understanding Islamic Finance, op. cit., p. 217
seller in acquiring the merchandize like freight, custom duty etc. shall be included in the cost price and the mark-up can be applied on the aggregate cost. To sale an item on Murabahah, ascertaining the exact cost is a necessary condition. Otherwise, the item will be sold on Musawamah (bargaining) basis i.e. without any reference to the cost or to the ratio of profit.

For Example, “A purchased a ready-made suit with a pair of shoes in a single transaction, for a lump sum price of Rs. 500/-. A can sell the suit including shoes on Murabahah. But he cannot sell the shoes separately on Murabahah, because the individual cost of the shoes is unknown. If he wants to sell the shoes separately, he must sell it at a lump sum price without reference to the cost or to the mark-up.”

Murabahah not always on Deferred Payment:

It should be clear from the above that either Murabahah or Musawamah is not necessarily a sale on deferred payment basis. In both, the liability for payment could be instant, or deferred to a future date. Payment could even be spread out over a period of time in instalments. Therefore, Murabahah need not always be a credit sale where the payment falls due at a later point of time. Murabahah, similar to other types of sale such as Musawamah and Tawliyah (sale at cost), could take place either on cash basis or on deferred payment basis.

4.9 Murabahah on Order and Promise (Murabahah *lil amir bi al-shira*/ *lil-wa’ad bi al-Shira*):

If there are three parties, the buyer, the seller and the Bank as an intermediary trader between the buyer and the seller, where the Bank upon receipt of order from the buyer with specification and a prior outstanding promise to buy the goods from the Bank, purchases the ordered goods and sells those to the ordering buyer at a cost plus agreed profit, the sale is called "Bai-Murabahah on

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39 Usmani, p. 103-104
Order or Promise”, generally known as Murabahah. This type of Murabahah is dominantly being used by modern Islamic banks and financial institutions.

Thus it is a sale of goods on profit by which ownership of the goods is transferred by the Bank to the Client but the payment of the sale price (cost plus profit) by the Client is deferred for a fixed period.

Being a mode of sale, all rules, conditions and ingredients of a valid sale remain applicable in Murabahah even when the latter is used for financing purposes. Observance of these rules is essential for the validity of Murabahah.

Mr. Ayyub dilates upon this form of contemporary Murabahah thus:

This arrangement wherein bank, upon request by client, purchases an item from third party and sell the same to him on a deferred payment basis is being widely used by almost all Islamic banks and financial institutions operating in various part of the world and by the Islamic Development Bank (IDB) for its foreign trade-financing operations. The need for this alternative arises from the following factors:

1. Commercial banks, and likewise Islamic banks, do not normally undertake business where they might be maintaining inventories of various goods; they do not want to become traders because inventory storage, space and holding cost might be expensive.

2. It may not be possible for Islamic banks to purchase all items in advance for Murabahah to their clients because the list of goods could be very long and there could be continuous additions to the list.

3. The clients might be in need of specific quality goods and the banks might not be even aware of the source of their availability. If banks keep similar items in inventory, these might not be acceptable to the clients.

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40 ibid
4. Regulators/central banks normally do not allow the banks to undertake trading as their core business, with the dual purpose of keeping them liquid/saving them from the asset and market risks related to goods and to avoid cartels and monopolies in the commodity market. As such, most of the Islamic banks purchase only those goods for which they receive requisition from their clients.

On account of the above, Islamic banks have been allowed not necessarily to maintain inventory of goods to be sold through Murabahah. According to the AAOIFI *shariah* standard on Murabahah, it is permissible for IFIs to purchase items only in response to their customers’ wish and application. But this wish may not be considered a promise or commitment by the client to purchase the items, except when the promise has been made in the due form.\(^4\) For practical purpose, the promise can be incorporated into the requisition form to be submitted by the client.

The customer can also indicate the supplier from whom the items/goods are to be purchased by the bank. But the bank will have to ensure that the supplier is any third party and that the client has not already purchased the item from that supplier or made a firm commitment with him to purchase, otherwise it would be *bai al-’inah* and the transaction would be non-*shari’ah* compliant. The bank can obtain a performance bond from the client to ensure that the supplier identified by him will function in good faith and that the item provided by him will be acceptable to the client.\(^5\) Similarly, the bank is not allowed to enter into a *Musharakah* arrangement with the client with the promise that one of the parties will buy the other’s share through Murabahah on either a spot or deferred payment basis. However, the promise can be made by a partner to buy the other’s share at

\(^4\) AAOIFI, 2004–5, *Shariah Standards* p.113
\(^5\) AAOIFI, 2004–5, op. cit, Standard on Murabahah, clause 2/5/1, p.116
the market price or at a mutually agreed price at the time of sale by means of a separate contract.\textsuperscript{43}

However, it does not mean that IFIs can not be involved in the sale/purchase of goods or can not create their inventories. Purchasing an item, taking its possession and ownership along with risk and reward is a major requirement of Shari'ah, without which the transaction would not be valid. Murabahah can not be used as a substitute for running finance facility, which provides cash for fulfilling various needs of the client. If a bank does not keep inventory, it can purchase a commodity on a customer's request and sell it to him on a cost-plus basis, but it will have to fulfil all the necessary conditions of valid bai as well as additional conditions applicable to Murabahah.

Merchant banking has become one of the functions of even conventional banks. Therefore, Islamic banks, in addition to conducting Murabahah on order, may like to establish specialized asset management and trading companies as non-bank financial subsidiaries to undertake active trading business by maintaining inventory of major items demanded by their clients. This way, their profit margin may be higher and customers may also be offered such items at cheaper rates.

Bank can purchase goods through any third person/agent and possess the goods before resale. If the bank appoints the customer its agent to buy the commodity on its behalf, the customer will first purchase the commodity on behalf of the bank and take its possession as such. But payment should be made by the bank directly to the supplier. Double agency, i.e. for making payment and for purchasing and taking delivery, should be avoided because it may become a cause of misuse, making Murabahah a back door to interest. At this stage, the commodity must remain at the risk of the financier, who is the seller in this

\textsuperscript{43} AAOIFI, 2004-5, Standard on Murabahah, p.113, 114, 116, 128; clause 2/2/1 to 2/2/5 and 2/5.
transaction. Thereafter, the client purchases the commodity from the financier for a deferred price.\textsuperscript{44}

It is clear from the above discussion that Murabahah is a lawful kind of sale but has its own limitations. The classical Murabahah was not a mode of financing, it was a kind of trade. Contemporary jurists have accepted it as a mode of business and an alternative to financing with certain limitations. These relate to the level of transparency and justice which shariah ordains for commercial activities. It is in view of this requirement that Maliki fuqaha consider this form of sale Naqis (defective).\textsuperscript{45}

There is no doubt that jurists have justified Murabahah on the grounds that it provides protection to the innocent, unskilled and inexperienced buyers, but as we do not find any reference regarding its prohibition for experienced people or traders, it can therefore be adopted subject to the fulfilment of the juristic conditions, as an alternative to interest-bearing transactions for those activities which the contemporary shariah scholars may allow.\textsuperscript{46}

De Lorenzo Y.T. opines thus:

"...In order to make the murabahah contract effective in the business of inventory or short-term trade financing. It was necessary to depart somewhat from the classical model by combining a promise to buy on the part of a client with the actual purchase by the bank of goods from third part suppliers. Then, in addition to the actual murabahah contract, a further transaction is appended; the promise to

\textsuperscript{44} Usmani, 2000a, p. 106; for principal’s ownership during agency, see Zuhaili, 2003, p.674 (as cited by Ayub (2007), op. cit, p. 223)
\textsuperscript{45} Ayub, Muhammad G. (2007), Understanding Islamic Finance, op. cit., p. 219
\textsuperscript{46} For details, see Council of Islamic Ideology, 1980, pp. 15, 16, 34, 35, 38, 42-46; the CII has described the detailed application of this mode in the chapter on “Commodities Banking”. According to the CII, it can be used both for “fixed investment financing” and “working capital requirements” of parties (pp. 34, 38). Farmers’ short term fund requirements, particularly for the purchase of inputs like seeds, fertilizer and pesticides and for plough cattle, tractors and tube wells can be met through Murabahah (pp. 34-45). The commerce sector can also be financed through this mode (pp. 45 and 46). As regards mining, quarrying, electricity, gas, water and consumption, consumer durables can be financed on a Murabahah- Mu’ajjal basis.
purchase that is made by the client or prospective buyer. This arrangement, however, innocent in appearance, actually brought up a host of issues for the early Shariah boards. Nonetheless, as the needs of modern trade were such that a Shariah-compliant alternative to trade financing by means of conventional, interest-based financing was required, the classical *murabahah* was transformed into the modern *Murabahah li’l-Amir bi al-Shira*, *murabahah* with an order to purchase that has now become commonplace to Islamic banking.

Following the success of this experience, Shariah boards went on to engineer and approve a host of hybrid nominates, using a single nominate like *murabaha* in different configurations like parallel *Murabahah*, reverse *Murabahah*, back-to-back *Murabahah* and reverse parallel *Murabahah* contracts:...

4.9.1 *Murabahah on Order: A Bunch of Contracts:*

Contemporary *Murabahah* also involves an agency relationship between the bank and any third party or even the client. The *Murabahah to Purchase Orderer* in this form would compromise three distinct contracts:

1. A master contract which defines the overall facility to be availed by an agreement to purchase or promise by the client to buy the article when offered by the bank. Instead of being a bilateral contract of forward sale, the ‘agreement to buy’ is a unilateral promise from the client which binds him and not the bank.

2. An agency contract whereby the agent, who could be a client or any third party, has to purchase the item from the market or the supplier identified by the client and take its possession on behalf of the bank; this should be separate from the *Murabahah* agreement.

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48 AAOIFI, 2004-5, Standard on Murabahah, p.130
3. The actual Murabahah contract should be concluded when the bank owns the concerned commodity.

Murabahah transactions that involve other contracts like promise, agency (Wakalah) and credit along with an agreed rate of return for IFIs over the cost price lead to a number of issues that will be discussed in detail later.

4.10 Bay’ Mu’ajjal & Murabahah:

All sales where the payment is deferred are known as Bay’ Mu’ajjal (credit sale) or sale on deferred (price). According to Justice Taqi Usmani, deferred credit sale are governed by the following primary conditions:

- The time of payment must be agreed in advance;
- If there is an increase compared with the cash price, it must be agreed at the time of sale and the buyer must have the true option to pay the lower cash price or higher deferred sale price; and
- The price may not be increased if there are delays in payment, but the remaining instalments may be accelerated if there are any defaults in paying the instalment on time.

Bunched with the Murabahah, Bai Mu’ajjal would mean sale with an agreed profit margin over the cost price along with deferred payment. It may be termed as ‘Murabahah Muajjal’.

Postponement of the payment is one of the general features of lawful sales. In Hidayah, permission of credit sale has been described thus:

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49 Usmani, M.T. op.cit, pp.102-103
50 ibid, p. 117
“A sale is valid either for ready money or for a future payment provided the period be fixed, because of the words of the Holy Qur’an ‘Trading is lawful’ and also because there is a tradition of the holy prophet (peace be upon him) who purchased a garment from a jew, and promised to pay the price at a fixed future date by pledging his iron breast coat. It is indispensably a requisite of business but the period of payment should be fixed. Uncertainty in the period of repayment may occasion a dispute and jeopardize the execution of the transaction since the seller would naturally like to demand the payment of the price as soon as possible, and the buyer would desire to defer it.”\textsuperscript{52}

Thus a valid sale may be concluded in which payment of the price is deferred and is made in instalments and in such a case, the period of instalment payment must be definitely ascertained and fixed.\textsuperscript{53}

When a Murabahah sale is carried out on deferred payment basis, all rules pertaining to sales on deferred payment become applicable. The due date of payment or the period at the lapse of which payment would fall due should be fixed in an unambiguous manner. If there remains any doubt as to when the payment would become due, the sale is void. The due time of payment can be fixed either with reference to a particular date, or by specifying a period, like three months, but it cannot be fixed with reference to a future event the exact date of which is unknown or is uncertain.

Similarly, the exact price must be clearly fixed at the time of sale. The price thus agreed may not be increased if the buyer fails to settle the amount on the due date. The deferred price may be more than the cash price,\textsuperscript{54} but it must be

\textsuperscript{52} Al-Marghinani, 1957, p.242 as cited by Ayub (2007), op. cit; p. 219
\textsuperscript{53} Al-Zuhaili – El-Gamal, Vol 1, (3.2.1 & 3.2.2), pp 53, 63 (citing al-Sarakhsi (1st edition), vol. 13, p.192), Al-Kasani, vol. 5, p.244, ‘Ibn al-Humam, vol. 5, p.109), and Ibn Abideen, vol. 4, p. 43 onwards), and 4.3.9, at pages 119-120 (noting that all four major schools of Islamic jurisprudence consider the installment sale a valid sale arrangement).
\textsuperscript{54} Delay in payment under Murabahah is also allowed in other schools of Fiqh, including Shiaites. (See, Al-Hilli, 1389 AH, p. 41, as cited by Ayub, op. cit., p. 220.) However, jurists slightly differ on the aspect of different cash and credit prices. The Hanafis, Shafi‘es and Hanbalis permit the difference between cash and
fixed at the time of sale. The seller is entitled to demand a security in the form of mortgage or pledge, or a guarantee from a third party. If the payment is in installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date, the remaining installments will become due immediately. The buyer can also be asked to sign a promissory note or a bill of exchange, but the note or the bill cannot be sold to a third party at a price different from its face value.\(^5\)

However, it is not allowed to conduct Murabahah on a deferred payment basis in the case of gold, silver or currencies, because all monetary units are subject to the rules of Bai-al Sarf. Similarly, receivables or debt instruments cannot become the subject matter of Murabahah, as any profit over the principal of a debt is *riba*\(^6\). However, Murabahah of shares of joint stock companies eligible on the basis of screening criteria is allowed.\(^7\)

### 4.11 Islamic Financing Techniques:

Before having a full discussion upon Murabahah financing method, it would be pertinent to discuss the various financing techniques used by Islamic Financial institutions in order to have a glimpse on their comparative advantages and applicabilities.

Keeping in view the *Shariah* considerations, Islamic banks around the world have devised many financial techniques that are basically derived from Islamic contract of partnerships, exchange, and the loans (Charity). For day-to-day banking activities, Islamic banks resort to these financial instruments that have been devised to satisfy the Islamic doctrine and provide acceptable financial returns to the investors. These are basic techniques, however, a certain degree of credit prices provided one price is settled at the finalization of contract. Although, imam Malik himself forbade it, some of the Malikis hold a different view and allow it. Contemporary jurists are almost unanimous on the legality of this difference.

\(^5\) Usmani, M.T., op. cit, p. 102
\(^7\) Ayub, op. cit., p. 220
variance in their practices may be observed from county to country and region-to-region. Some times the same techniques are called, pronounced or spelt differently in different regions as they all are derived from the Arabic sources. Following section gives a brief account of the Islamic financial techniques adopted by the Islamic banks worldwide. These can be grouped under three broad categories.

A: Contracts of Partnership

1. **Mudarabah (Capital Financing):** Also known as trust financing, this is an agreement between two parties one provides the capital and the other known as 'Mudarib' uses his entrepreneurial capabilities and manages the fund and the project. The profit arising from the project is distributed according to a predetermined formula. Any losses accruing are born by the provider of the capital. The provider of the capital has no control over the management of the project.

Under Islamic banking the bank acts as a manager of customers' funds. The depositors on the other hand are known as 'Rabb-al-Mal' meaning the owner of the fund. The bank on its own risk invests deposits accepted on savings under the profit sharing and loss absorbing agreement. Customers give authorization to the bank to invest funds and share profit or absorb loss on agreed proportions. Account holders of this type of account are required to maintain a minimum balance in the account.

Capital Trust financing is a contract between at least two parties in which the bank as the investor supplies the entire capital of the business forming a relationship between the supplier of capital and the user of capital. These two parties work together and share profits and bear the losses. A notable point of this agreement is attachment of the liability to loss to the financier only; the working party i.e. the user of the capital bears no part of the loss accruing to the capital extended by the financier. His only loss will be his labor, which will get no reward.
2. Musharakah (Partnership): This technique involves a partnership between two parties who both provide capital towards the financing of a project, both parties share profit on a pre agreed ratio, but losses are shared on the basis of equity participation. The both or any of the party may carry management of the project.

In this case the bank and the customer jointly contribute capital. They also contribute managerial expertise and other essential services at agreed proportions. Profits are shared according to the contract agreed upon while losses will be shared according to capital contribution. An individual partner does not become liable for the losses caused by others.

B: Contracts of Exchange

1. Murabahah (Cost plus profit): This is a contract sale between the bank and its client for the sale of goods at a price which includes a profit margin agreed by both the parties. As a financing technique it involves the purchase of goods by the bank as requested by its client. The goods are then resold to the client with a markup usually received in specified installments.

2. Ijarah (Leasing): A contract under which a bank buys and leases out for rental fee equipment required by its client. The duration of the lease and the rental fees are agreed in advance. Ownership of the equipment remains with the bank. This is similar to the conventional leasing. However, in the conventional leasing system the lessee pays specific rentals and a fixed rate of interest over a given period for the use of specific asset. But in the Islamic banking system of leasing the risk related to leasing has to be shared between the bank and the lessee, in case of any damage to the leased assets.

3. Ijara-wa-iqtina: Very similar to Ijarah except that there is commitment form the client to buy the equipment at a pre agreed price at the end of the lease. In this case rental also includes the costs of the equipment.
4. **Bay al-Salam**: A contract for sale of goods where the price of the said item is paid in advance. In this system a buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique is similar to a future or forward-purchase contract and is particularly applicable to seasonal agricultural purchases. Under Islamic banking this technique is generally used to buy the goods particularly raw materials in cases where seller needs working capital before he could deliver.

5. **Bay Bithaman Ajil (BBA)**: This contract refers to the sale of goods on deferred payment. In this system the Islamic bank buys the item requested by the client and sells it to the client on pre agreed installment including the cost of the equipment and the markup. This is very similar to *Murabahah* except the payment is made in installments some time after delivery of the underlying goods.

6. **Istisna**: A contract of acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of a job completion. This is practiced for purchase of an item that is yet to be completed or produced, for example, a house to be constructed where payments are made to the developer or the builder according to the stage of work completed. *Istisna* differs from *ijara* in that the manufacturer must procure his own raw materials. Otherwise the contract would amount to a hiring of the seller's wage labor as occurs under *ijara*. *Istisna* also differs from *bay salam* in a sense that (a) the subject matter of the contract is always a made-to-order item, (b) the delivery date need not be fixed in advance, (c) full advance payment is not required and (d) the *Istisna* contract can be canceled but only before the seller commences manufacture of the agreed item(s).

C: **Contracts of Charity**

1. **Qard Hasan (Interest free loan)**: *Qard Hasan* means an interest-free loan, given by the Islamic bank to the needy people in a society. The practice of dealing with this sort of investment differs from bank to bank. *Qard Hasan* is
normally given to needy students, small producers, farmers, entrepreneurs and economically weaker sections of the society, who are not in a position to obtain loan or any financial assistance from any other institutional sources. The main aim of this loan is to help needy people in a society in order to make them self-sufficient and to raise their income and standards of living.

This principle is also practiced in case of Islamic banks accepting deposits from public. Depositors of this account do not receive any return, however, if Islamic bank wishes it might grant some financial or non-financial benefits to its depositors.

2. **Gifts:** This is actually a form of voluntary charity, encouraged under Islam. In Islamic banking this is used to oblige the depositors who have kept their money in Islamic bank without hoping any return. These cases are especially noticed in Malaysia and Iran where Islamic banks offer some gifts to the depositors to compensate for any losses they might have incurred by choosing to deposit in an Islamic bank. This is often commensurate with the conventional banks’ interest rate. In Malaysia, for example, ‘Government Investment Certificates’ (GIC’s), which do not carry any interest to the lender, is compensated by offering gift at the end of each loan period.
CHAPTER - V

DEVELOPMENT OF CONTEMPORARY MURABAHAH
5.1 **Murabahah in Theory**:  

During the second half of the first Hijrah century a new sort of business transaction developed which was reported by Imam Malik in his famous work "Al- Muatta" under the caption "Sale at a mutually agreed profit margin". This sale transaction has been widely accepted, adopted and practiced as a lawful business method by the Islamic Banks and financial Institutions (IFIs).

Let us begin by quoting what Imam Malik said:

"Yahya told me that Malik said": there is unanimity of opinion in our place (al-Madinah) regarding cloth purchased by a person in a town and then takes it to another town wherein he sells it at a mutually agreed profit margin. The money paid to the commission agent (the middle man) will not be computed (in the sale price) nor the cost of packing and building. (Moreover) the (personal) expenses (incurred by the businessman) will not be included nor the house rent. As far as it is concerned with the costs of transportation (of the cloth) they will be computed as a part of the basic price but no profit will be added to it unless the seller advises the bargainer about all of them. If they agree to let him have profit on all of them after knowing about them, it is not objectionable.

Malik said: So far as it is concerned with making the cloth white and tailoring charges and colouring costs and similar expense, a profit margin will be

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1 This section is mainly based on al- Kaff's work "Al Murabaha in Theory and Practice" published by Islamic Research Academy, Karachi, Pakistan.
allowed for them as they are just like cloth for which profit margin is computed. . . ."²

Following points can be inferred from the above statement:

1) The seller himself took the initiative of buying cloth without the knowledge and consent of the would-be buyer.

2) The seller bought it in one town and transported it to another town to sell it.

3) This is a pure sale transaction which is concluded by exchanging goods and prices with mutually agreed profit margin then and there. No credit is involved.

4) Profit margin could not be added to certain items such as cost of transportation.

5) Certain items like workmanships are treated as the part of the basic price.

Thus, according to Imam Malik, Murabahah is conducted and completed by exchanging goods and price including a mutually agreed profit margin, then and there.³ It is important to note that to him, no credit is involved in Murabahah. Malikis as a whole do not like this sale as it requires so many conditions, the fulfillment of which is very difficult. However, they do not prohibit it.⁴

Imam Shafi‘i extended this concept to include credit transaction as well as goods whose specifications have been described by the buyer to the seller. Imam Shafi‘i says:

“If a person shows another person a commodity telling him: purchase this (for me) and I shall give you such and such profit margin. This deal is lawful. The person who offered the profit margin enjoys the option of either completing the

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⁴ Al-Jaziri, 1973, p. 559 (as cited by Ayyub, ibid.)
deal or leaving it complete. Similarly, if he tells: purchase for me a commodity which he specifies or any commodity you choose and I shall give you such and such profit margin, this is all the same and the first deal is lawful. He, in what he gives from his free will, shall enjoy option (to complete the deal or not). It is same in the case whose specifications are stated if he says: purchase for me that and I shall purchase it in cash or on credit. The first deal shall be lawful. They shall enjoy option in the completion or otherwise) of the second deal, it shall be lawful. If they conclude the deal on the condition that both commit themselves to the first deal, it shall be null and void for two reasons. First because they concluded the deal before the seller obtained the ownership (of the goods in question). Secondly because he (the would-be seller) is exposed to risk (in view of your condition): if you purchase at such and such price I shall let you have such and such a profit margin."

Thus, we notice that Imam Shafi’i:

1. Regarded the sale at mutually agreed profit margin involving goods with specifications as lawful and legally valid.

2. Considered the sale at mutually agreed profit margin in which the seller purchases any goods he opts as lawful and legally acceptable if authorized to do so by the buyer.

3. He regards "the order of purchase" a complete separate agreement from the actual contract to buy/sell. He, therefore, gives the option to the buyer only in the second sale deal while he grants option to both of them in the second sale deal because of the risk faced by the seller in his inability to acquire at the price fixed by the buyer in addition to the non-ownership and non-possession of the goods by the seller.

(4) He allowed the sale by means of cash or on the basis of credit (debt/deferred payment) (up to a certain period of time); but he did not clarify whether there is going to be a difference between the cash and credit price.\(^6\)

Taking all the above mentioned conditions stipulated by Imam Shafi’i into consideration, Dr. Sami Hassan Ahmad Hamoud first\(^7\) suggested a solution which leads to the expanded version of *Murabahah* concept visualized by Imam Shafi’i. In his presentation of the *murabahah*, Hamoud quotes Ibn Qudamah who defines it as follows:

*Murabahah* is selling for the cost prince plus a specified profit, provided that both the seller and the buyer know the cost price. The seller says, ‘my capital, or the cost price, is a hundred, and I sell it to you for a profit of ten’. This is permitted and there is no doubt about its legitimacy. No scholar is reported to have regarded it with legal dislike (*karahah*).\(^8\)

However, to incorporate a purchase order in this transaction, Hamoud turns to Imam Sahafi’i.\(^9\) What Imam Sahafi’i specified has led Hamoud to develop the financing mode called *bai‘ al murabahah li al ‘amir bi al shira* (sale with declared profit to the purchase order i.e. the mark-up).

Sami states as follows:

\(^6\) Al- Kaff, op. cit, p. 10 (Here al-Kaff remarks as: ‘However, the use of word ‘debt’ (by Shafa’i) seems to suggest that he would not allow an addition to the cash price as any addition to the debt is unlawful.’

\(^7\) Here we mean that the first scholar who treated Murabahah at length is dr. Sami Hassan Hamoud who stated this type of sale assigning it the title “Sale at the mutually agreed profit margin” in his dissertation entitled “Development of a banking System compatible with the Islamic Law” for which he obtained his Doctorate from the Law College of the Al-Azhar University, Cairo. It appears from page 430 to 434 in the 2\(^{nd}\) edition of his book carrying the same title published in Cairo in 1402-1982 under the caption: “Third-Sale at the mutually agreed profit margin for the order of the purchaser”.


\(^9\) Hamoud quotes Shafi’i thus: “If a man shows certain goods to another and says, ‘buy this for me and I will give you so much profit’, and the second man buys it; then the transaction is permitted. However, the one who has made the promise has the right of withdrawal. If he buys, it makes no difference whether he pays immediately or at a later date. So, the first sale is valid but there is no commitment as to the pother; they are at liberty.” (ibid)
“Therefore, when we look at a solution to this problem, we find that it opens door for the interest free bank for assisting a person in obtaining the commodity he is in need of on the basis of monthly installments or some similar arrangement but the initiative must come from the consumer and not from the businessman.

For example, this consumer (a doctor who wishes to acquire some medical equipment for his new dispensary) approaches the bank with a request to purchase the required equipment with the specifications stated by the Doctor and on the basis of his promise to purchase those equipment actually needed by him at a mutually agreed profit margin say (2% or 3%) repayable by monthly installments as per dictation of his income.

This deal is made of a promise to purchase and sell on the basis of mutually agreed profit margin. (This is the opinion of Sheikh Faraj Al- Sinhori when the matter was presented to him at his residence in Al- maadi District of Cairo on 9/8/1975).

It is not one of those cases in which a person sells what is not owned and possessed by him because the bank is not offering something for sale but receiving a purchase order. It is not selling until it owns what has been ordered and displays it to the buyer to see whether it is according to specifications stated by him. Moreover, this operation does not entail profit against what he could not guarantee because the bank after its purchase becomes its owner carrying the risk of damage or are broken down before their delivery to the doctor, their loss is to be borne by the bank.

……..a disagreeing person may ask: What happens if, for example, the doctor falls back and does not keep his promise?
We say: how much percentage from those who do not keep their promises? If once a train derails, does the railroad company decide not to operate the trains so that the same experience does not occur? \(^{10}\)

He further goes on to say:

"Both the bank and its client have opted to abide by their promises and to shoulder the consequences of going back on their commitments. Moreover, the copy (of the goods in question) agreed between the bank and its client is a "Delayed Value". Mostly, in the determination of (delayed) value, the repayment period is taken into consideration as done by anyone who sells (on the basis of) delayed payment." \(^{11}\)

Mr. Al-Kaff has pointed \(^{12}\) some possible objections to Sami's theory that may be raised, as follows:

1) Primarily banks are financial intermediaries whose main intention is to provide finance to the commerce and commercial community. Their interests do not lie in becoming business institution engaging in trading practices.

2) Dr. Sami has failed to mention whether the cash value and the installment (credit) value of the commodity would be the same in both cases or there would be a difference? This is a vitally important question because the second margin, if any, would turn the whole operation into an interest generating deal in which the bank would be charging interest against the time granted.

\(^{10}\) Sami Hassan Ahmad Hamoud (1982), "Tatweer al-Amal al-Masafiaya", Cairo, second edition (as cited by al-Kaaf, op. cit., pp. 11-12

\(^{11}\) Hamoud (1984), "Development of a banking System compatible with the Islamic Law", 2nd ed., Cairo, pp. 36-37

To conclude, the concept of Murabahah[^13] li'l Amir bi-al Shira was first introduced in contemporary Islamic finance in the mid 1970s by Sami Hamoud (a well known Jordanian economist and banker), based on a *fatwa* by Sheikh Faraj al-Sanhuri.[^14] Pointing out the limitations of classical mudarabah principle in its application to the modern needs of financing, Hamoud invited attention to the cases where it is incapable to provide financing e.g., consumer's goods, goods supplied to government and industry, etc. Hamoud was searching for an Islamically acceptable financial instrument capable of competing with conventional consumer finance.[^15] Islamic financial Institutions welcomed the addition of this new alternative from *fiqh* that allowed them to replace a significant part of their practice of high-risk financing. Since the publication of Hamoud 'Tatwir al-A'mal al-Masrafiyyah' (1982) murabahah emerged as a technique different from profit & Loss sharing (PLS) modes consisting of Mudarabah and Musharakah. It also became the backbone of contemporary Islamic banking. Murabahah is shown for the first time in Islamic Development Bank (IDB) operations in the year 1397 H (1976). The quantitative value of this operation was US $ 50.52 million, substantially high compared to other modes of operations. This operational mode became popular among the Islamic banks to the extent that in 1984 it covered 84 % of the operations of five Islamic banks on average.[^16] According to Tamimi, the use of Murabahah as a major method by IBs was approximately estimated 75% of their assets.[^17] This percentage is roughly true for Murabahah financing is one of the most commonly used means of Islamic Finance. The full technical name of this contract is “a credit sale with mark-up to one who ordered the initial purchase” (al-murabahah lil-amir bi-l-Shira ma'a bay bi-thaman 'ajil). Sami Hamud envisioned this early transaction by adapting it as a substitute for bank loans in his book *Evolution of Banking Operation in a Manner that Agrees with Islamic Law (Shari'ah)* (which was based on his Ph.D. dissertation). Over the years, a number of additional alterations have been added to make it a better alternative to interest bearing loan. Hamud, Sami Hasan Ahmad (1976), Tatweer al-Amal al- Masrafiyyah bi ma Yatta'fiq wa al-Shari'ah al-Islamiyyah, al-Qahirah: Dar al-Ittihad al-Arabi li'l Tiba'ah, p. 497[^13] Ibid., pp. 476-481. Ahmad, Ziauddin (1985), Some Misgivings About Islamic Interest free Banking, Islamabad: IIIE. (as cited by Monzer Kahl and Taniquiah Khan (1992), Principle of Islamic Finance: A survey, IRTI/IDB. Jeddah, KSA, p. 23 available at [http://www.irrtms.org/OpenSave.asp?pub=27.pdf](http://www.irrtms.org/OpenSave.asp?pub=27.pdf))[^16] al-Tamimi, “Experience of Islamic Banks in the Middle East”, p. 33 (as cited by Saeed, A., 1999, p. 78)
many Islamic banks as well as Islamic banking system in Pakistan and Iran. As early as 1984, in Pakistan, *murabahah*-type financing amounted to approximately 87% of total financing in the investment of PLS deposits. In the case of Dubai Islamic Bank (the earliest private sector Islamic bank), *murabahah* financing amounted to 82% of the total financing for the year 1989. Even for the Islamic Development Bank (IDB), over a ten year period of financing, 73% of its total financing was on *Murabahah* basis, that is in its foreign trade financing.

5.2 *Murabahah in Practice*:

Having taken a brief glance at classical Murabahah contracts in general, we may now discuss how this concept could be applied in financing. It is essential to note at the outset that being a trading product in its origin, Murabahah is never the ideal mode advocated by Muslim jurists for financing. It should be restricted to occasions where the proper modes of financing are not adequate. Due to the same reason, adopting Murabahah for financing purposes is never without difficulties. For its acceptability from a Shari’ah point of view, the numerous conditions imposed should be strictly fulfilled. If these conditions are not followed, Murabahah financing may become similar to an interest bearing loan.

Financing on Murabahah can be employed only when a client genuinely requires procuring an asset from an outside source. The term ‘financing’ is used here to indicate purchasing the item required by the client from the indicated source and later selling it to the client. It does not mean extending a loan facility to the client so that he may purchase the item himself. Thus, when an asset such as a vehicle, land, building, raw material, merchandise, etc is needed to be purchased, it may be financed on the basis of Murabahah. Instead of assets, if

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18 Khan, *Profit and Loss Sharing*, p. 145 (as cited by Saeed, p. 78)
21 This section greatly benefit from the elements of Section ‘Murabahah’ of Muhammad Taqi Usmani’s book “*An Introduction to Islamic Finance*” 2005, Idara Isha’at-e-Diniyat, (P) Ltd., New Delhi
22 Usmani, op. cit., p. 105
money is required for some purpose, Murabahah financing cannot be employed. This is because Murabahah is a genuine sale transaction where actual commodities are sold, and not a transaction of lending. Therefore, if cash is required for overhead expenses such as settlement of utility bills, payment of wages, transport, processing etc, or for purposes such as settlement of loans and payment for goods already purchased, Murabahah financing may not be employed. Similarly, if a service or usufruct is required, Murabahah may not be used for financing it.\(^{23}\)

In financing, Murabahah takes the form of a complex procedure comprising of several transactions, reflecting several relationships between the parties involved. In this type of financing, the financial institution sells the commodity required by the client on deferred payment basis through a properly executed contract of Murabahah sale. This necessitates the financial institution having come into ownership of the necessary commodity beforehand, and having the item at its risk at the time of sale. If the financial institution concerned happens to own stocks of the commodity required, this could be facilitated with ease, which would be welcome from a \textit{Shar'i} point of view too as some questionable practices could be avoided. (Indeed, in a proper Islamic set up, rather than being content with providing finance, Islamic financial institutions are expected to play an active role in trading as well, and currently there are Islamic banks that also maintain trading wings dealing in vehicles etc for providing Murabahah.) However, since financial institutions in the current set up typically do not own stocks, the article required by the client has to be purchased from elsewhere, usually from a source indicated by the client himself. This results in the introduction of several further intricacies to the Murabahah procedure, resulting in the complex product known as “\textit{saie on Murabahah to the orderer-to-purchase}” (\textit{Bay’ al-Murabahah li-al-Āmir bi-al-Shirā’}).\(^{24}\)

\(^{23}\) ibid.

\(^{24}\) Usmani, op. cit, p. 106
5.2.1 Major Phases in Murabahah Financing:

The major phases in this procedure at the primary level could be stated in brief as follows.\(^\text{25}\)

First, the client requests the financial institution to purchase a certain commodity from an external source for subsequent sale to him.

Second, the financial institution purchases the commodity, usually on cash terms, and takes possession.

Third, the client purchases the commodity from the financial institution on deferred payment basis, and later settles the price on the due date in instalments as agreed.

It would be seen that this procedure consists of an initial agreement by the financial institution to buy the item required by the client followed by two transactions of sale. If each of these steps takes place in a manner acceptable in Shari’ah, the transaction would be complete.

The initial request made by the client that the financial institution procures the required commodity from the market could, when necessary, take the form of a unilateral promise made by the client to the bank. Here the client promises that when the bank purchases the asset from the market, he would subsequently purchase it from them at a pre-agreed price calculated on cost plus mark-up basis. This is to eliminate the possibility of the client refusing to purchase the asset from the bank after the latter had procured it from the market. It is essential here that only the client binds himself to purchase the asset from the bank, while the bank does not promise to sell the asset to the client. This is to avoid entering into a bilateral promise binding both parties to contract a sale on a future date, resembling a forward sale which is prohibited in Shari’ah.

\(^{25}\) Usmani, p. 107
The two transactions of sale that follow this promise, where the bank purchases the commodity from the market first and sells it to the client second on cost plus mark-up basis, should both complete the relevant conditions for sales in Shari’ah. Thus, the bank should unequivocally purchase the item preferably through its own channels and take possession of it, either physically or constructively. Here constructive possession means having the item in the bank’s risk for a period of time, so that if the item is destroyed in that period the full responsibility devolves on the bank. The bank may procure the item from any supplier at its discretion, or purchase from a source indicated by the client. The subsequent sale to the client should take place after the bank had thus purchased it first and had borne its risk for some time. The bank transfers ownership of the asset to the client through a properly executed contract of sale, whereby the risk is transferred to the client for the first time.26

5.2.2 Possible Procedure of Murabahah:

Trading and other real sector business intensely need particular expertise. For Islamic banks, it is too difficult to train all staff in trading, marketing and other real sector activities needed for banking practices. Banks may set up some specialized concerns to carry out trading activities and involve in buying and selling commodities to customers on the basis of deferred payment and the staff with relevant specific expertise may be assigned the job of trading in goods so as to fulfil the Shari’ah prerequisites of Murabahah- Mu’ajjal. It would help them use their entrepreneurial expertise to earn more profit. The other options to conduct such trading activities may be either through the client as agent or through a third party agency. These possible options for conducting Murabahah are briefly discussed below.

5.2.2.1 Direct Trading by Bank

26 Usmani, op. cit., pp. 107-109
Direct trading by bank itself is the most ideal option with regard to meeting the murabahah prerequisites, but involving the banks in such business activities directly could lead to a lot of managerial problems and other predicaments which requires the induction of effective internal controls to sort out the issue.

In the absence of such controls, this structure could be used only in cases of selected certain goods, wherein banks could buy any high value asset or specific goods with trademarks in bulk for building inventory and sell on a cost-plus basis. For example, a bank’s subsidiary dealing with agriculture finance may purchase fertilizer/pesticides and provide them to farmers on the basis of murabahah through dealers. In such wholesale business, an additional benefit would be that the bank’s sale price could be closer to the cash market price.

5.2.2.2 Bank Purchases through a Third Party/Agent

Another option may be to buy goods through a third party agent to maintain inventory or to purchase according to customers’ request for Murabahah operations. This structure would most likely to meet Shari’ah requirement of taking possession and business risk by the bank for the period between procuring the goods from the supplier and selling them to the customer on Murabahah. After purchase from the supplier, banks stand liable if anything goes wrong until transferring the goods to the client. The customer can not guarantee the risk of transportation of the goods because the safety of the goods is the liability of the owner, i.e, the bank. Banks can mitigate this risk by instructing to get delivery at their godowns.

Banks may appoint qualified suppliers as agents for purchase according to their inventory-creating plans or as and when required by their clients. For the latter agreement, the package would comprise (i) an MoU or agreement to sell: the

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27 According to AAOIFI standard, the option of a third party agent is better, it recommends that the customer should not be appointed to act as agent for purchase of the items for Murabahah except in situations of dire need (clause 3/1/3, p. 117).
28 AAOIFI, 2004-5, p. 129
client's request and his promise to buy the specified commodity from the bank; it may also include a term about the profit margin to be taken by the bank and, if possible, the sale price (that will include the cost price), the contract price and the payment date; for the profit margin, the bank may specify at this stage any reference rate provided a definite price is fixed at the time of execution of Murabahah;\(^{29}\) (ii) the sale deed executed at the time when the commodity is in the ownership and risk of the bank; and (iii) the 'promissory note' signed by the customer to the effect that he will pay the price of the goods purchased on a specific date. In addition to this the agreement may include the clauses about the security/collateral, description and quality of goods and the way out in case of defect in the goods and non-payment by the client at the due date. According to the AAOIFI standard, a promissory note or other guarantee can be obtained from the customer at the promise stage also.\(^{30}\) Of course, it is better that promissory notes be obtained after execution of the sale, because these generally have the wording “against value received”.

5.2.2.3 Bank Appoints the Client as Agent to Purchase

The above illustrates the preferable procedure for Murabahah which could be adopted by financial institutions. However in practice, an additional dimension is usually added to the above transaction that further complicates the matter and makes the procedure immensely vulnerable to abuse and foul play. This is the appointment of the client himself as the agent of the institution for purchasing the asset on latter’s behalf. Due to the introduction of this element, the distinction between the two sales and therefore between the two distinct ownerships, i.e. the ownership of bank first and the ownership of the client second, becomes marginal, making the involvement of the bank in the transaction similar in appearance to that of a conventional financier who takes no part in the risk. We shall see below how this development affects the Murabahah transaction.

\(^{29}\) AAOIFI, 2004-5, p. 120
\(^{30}\) AAOIFI, 2004-5, p. 121
As stated above, the bank procuring the required asset through its own channels and keeping it in its own possession is preferable to getting the client involved in the process. There is no harm in purchasing from a supplier indicated by the client, as long as the client does not play any role in the purchase. This would make the bank’s ownership of the goods more pronounced, and the subsequent sale to the client would appear more genuine. Any additional cost involved in the process could be added on to the cost of Murabahah for mark-up calculation.

However, due to various reasons, most financial institutions do not find this method convenient. Therefore, they prefer appointing the client himself who sought the Murabahah facility as the agent of the institution for purchasing the required asset on behalf of the institution. While this practice is correct in theory and therefore could be adopted when direct purchase from the supplier is not practicable due to some reason, it invariably results in increasing the complexity of the transaction, as now the bank and the client have to act in different capacities in different stages, and makes the point of transfer of the asset’s ownership to the client become somewhat obscure.

In appointing the client himself as the purchasing agent of the bank, it is necessary to understand that when the client first purchases the asset from the supplier in this capacity, the asset enters into the ownership of the bank, and not the ownership of the client himself. When he takes possession of the asset as the bank’s agent, it would be regarded as possession by the bank, and the risk of the asset is transferred to the bank. Any loss befalling the asset at this stage would be borne by the bank solely, provided the client had discharged the duties of agency diligently, as the client is only a trustee holding assets belonging to the bank. Consequently, the client is not permitted to consume or utilise the asset in anyway at this stage, as this would amount to breach of trust.
The asset would enter the ownership of the client only when the second contract of sale is finalised between the bank and the client, whereby the bank would sell the asset to the client on Murabahah terms as agreed. With this sale, the client would become owner of the asset, and start to bear the risk of the asset. Utilising the asset or consuming it becomes lawful for the client only after he purchases the asset thus from the bank through the second contract.

To conclude, the structure of trading through a client as the bank’s agent appears to be the safest mean to avoid commodity-based risks and related problems. But this arrangement to make Murabahah transaction a back door to interest, and therefore requires extra care to keep it shariah compliant. The foremost requirement is that goods come under the ownership and risk of the bank. Further, the customer should clearly explain to the supplier about his agency status.\textsuperscript{31} If the bank does not purchase and own the goods and only makes payment for any commodity directly bought and received by the customer from the supplier, that will be a remittance of the amount of money on behalf of the customer, which shall be nothing but a loan to him and any profit on this amount shall be nothing but interest.\textsuperscript{32}

**The Client as Bank’s Agent to Buy and Related Matters:**

The general structure of contemporary Murabahah is the following:

1. The customer approaches the bank with a request for the purchase of any commodity.

2. The bank appoints the client its agent to buy the item.

3. The bank purchases the commodity through the client as agent.

4. The bank makes payment to the supplier.

5. The client takes delivery of the item on behalf of the bank as agent.

\textsuperscript{31} AAOIFI, 2004 -5, clause 3/1/1, pp. 117, 130.
\textsuperscript{32} Ayub, Muhammad G. (2007), *Understanding Islamic Finance*, op. cit p. 222
6. The client makes an offer to purchase and the bank accepts the offer—the transfers the title over to the customer upon execution of Murabahah.

7. The customer makes payment on a deferred basis without any rollover, discount or rebate.

The above structure involves the following stages/steps: pre-promise understanding; promise stage, agency stage; acquiring possession, execution of Murabahah, post-execution of Murabahah. Each of these steps is crucial on its own right and neglecting essentials of any stage would render the whole arrangement unacceptable from shari’ah angle:

1. The client and the bank sign an MoU or ‘agreement to sell’, whereby the bank undertakes to sell and the client promises to buy a commodity for a purchase price plus a profit margin of X % that may or may not be tied with any benchmark, or a stipulated amount over the known cost.

2. The bank appoints the client as its agent for purchasing the commodity on its behalf, and both the parties sign an independent specific or general purpose agreement of agency.

3. The client purchases the commodity on behalf of the bank and takes its possession, for which the bank makes payment to the supplier. This is obligatory according to the AAOIFI Standard. However, some Islamic banks do not follow this instruction due to some procedural problems. The purchase order, material receiving report and delivery cahallan, under whatever title, should be in the name of the bank.

4. The client informs the bank that he has purchased the commodity on its behalf, has taken possession thereof, and makes an offer to purchase it from the

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33 This is different from the ‘actual sale agreement’ in which ownership rights are transferred to the buyer upon signing of the agreement. In an ‘agreement to sell’, a promise is made to sell any commodity in the future and it does not involve conveyance of the ownership rights.

34 AAOIFI, 2004-5, Standard on Murabahah, 3/1/4, pp.117, 118

35 Usmani, 2000a, pp. 107, 108 (as cited by Ayub, op. cit., p. 226)
bank at a profit margin over the cost, as agreed to in the agreement to sell’. This must be before the goods are consumed, otherwise the Murabahah will be invalid.

5. The bank accepts the offer and the sale is concluded, whereby the ownership as well as the risk of the commodity is transferred to the client.

The nature of the relationship in the above arrangement would be:

2. Bank and client: promisor and promise.
3. Bank and supplier: buyer and seller.
5. Bank and client: creditor and debtor.

Prerequisites of various stages of Murabahah to purchase orderer with the client working as agent are discussed below:

Pre-Promise Stage- Facility Approval

The following points have to be kept in mind while approving the facility; it is essential that the transaction between the bank and the client must be genuine, involving the trade of goods. Murabahah can not be used for providing liquidity or for cash financing. At the time of facility approval, banks should ensure that the client needs some goods. Further, this should exclude any prior contractual relationship between the client and the supplier whom the client is indicating for supply of the goods. It is not permissible to transfer a contract that has already been executed between the client and the supplier because this is tantamount to Bai’ al-‘inah, which is prohibited. However, if any, such prior understanding has not been finalized, the bank can enter into Murabahah arrangement. The bank must also ensure that the supplier or the party from whom the item is being purchased is a third party and not the customer, his agent or any entity with more than 50% ownership by the customer.
The nature of the required commodity should be in the scope of valid Murabahah. Commodities that are subject to the rules of Bai‘al-Sarf, like gold, silver and currencies, are not valid for Murabahah, because in such commodities and monetary units, exchange has to be hand to hand.\textsuperscript{36} The bank should also analyse the nature of goods from a risk management point of view, their marketing, any uniqueness that could affect their profitability and the cash flow and risk profile of the client.

**Promise Stage – Master Murabahah Facility Agreement**

After the initial analysis of the customer’s request, the bank will enter into a master Murabahah facility agreement, or MoU, in which the limit of the facility, the nature of the commodity, the profit margin to be taken by the bank, the schedule of payment, the security to be submitted by the customer and other terms and condition will be mutually stipulated. On the basis of one MoU there could be a number of consignments for purchase of the asset from time to time under sub-Murabahah. The MoU should also include the specimens of purchase requisition, a delivery report, a promissory note and the nature of collateral required. If both parties agree, the agency agreement can also be signed at this stage.

**Purchase Requisition**

As per the MoU, the client will submit a requisition to the bank to purchase the commodity as per his specifications. The requisition will contain details of the goods required to be purchased from the bank and if possible the name of the supplier, cost price and the expected date of delivery. Also at this stage, the bank should ensure that the goods are not already owned by the client, otherwise the shari‘ah advisor might ask the bank to credit the income from this transaction to the Charity Account. The customer will also give an undertaking to the bank that he will buy the goods which the bank will acquire on his request. Normally, a purchase requisition contains this promise. If the supplier is nominated by the

\textsuperscript{36} AAOIFI, 2004- 5, Standard on Murabahah, clause 2/2/6, p. 119
client himself, the bank may demand a performance bond or guarantee for good performance to the effect that the goods provided by the supplier indicated by the client will be acceptable to him.

Earnest Money (Hamish Jiddiyah) can be demanded from the customer to assess his sincerity to purchase the goods and as a security deposit. If the bank purchases the goods and the client backs out and does not purchase, the bank may sell the goods in the market and recover the actual loss, if any, from the Hamish Jiddiyah. However, the bank can not recover the conventional “cost of funds” or liquidated damages in the form of “opportunity cost”.

For purchasing the commodity it is advisable that the bank makes payment directly to the supplier to ensure that the funds are used for the actual purpose. Experience has shown that if funds are given to the client, there is a chance of misutilization that could also involve non-Sharia'h compliance. Advance payments can also be made to the supplier, and in this case, the bank would charge a higher profit margin than the case of post-supply payment.

*Agency Stage*

An agency agreement can be signed side by side with the signing of an MoU. But it should invariably be before the purchase of goods by the client. If the client purchases the goods before the agency agreement, it would mean the goods are already owned by him and the transaction would become Bai-al-'inah, which is prohibited. An agency agreement could be “specific agency”, when the purchase of the commodity is not of a consistent nature.

*Purchase Stage*

The client should purchase the goods as the agent of the bank and as per the specifications already decided. A number of situations could evolve at this stage. If the cost price is already given and the supplier gives some rebate, it should be

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37 AAOIFI, 2004- 5, Standard on Murabahah, clause 4/2, p. 119
passed on to the client at the time of execution of murabahah sale by reducing the cost of sale. If there is a rise in prices and the amount escalates from the amount agreed in the Murabahah limit., the bank or the principal must be informed in order to make the decision on whether to accept it or not. The bank has the right to reject the purchase if made at other than the agreed price. If the goods to be purchased are different from those given in the agency agreement, the change of the commodity can be made with mutual consent. Normally, banks indicate a time within which purchase has to be made and if there is a delay, the bank may ask the client to refund the cost of goods without any opportunity cost.

*Acquisition of Title and Possession of the Asset*

For Shari’ah compliance, it is necessary that the bank takes ownership and actual or constructive possession of the goods before the execution of Murabahah. The forms of taking possession of items differ according to their nature and customs. The requirement from the *shari’ah* angle is that the goods must come under the responsibility and risk of the bank. The *Islamic Fiqh academy* of the OIC resolved, in its sixth session, in respect of the form of possession:

Just as the possession of commodities may be physical, by taking the commodity in one’s hand or measuring or weighing the eatables, or by transferring or delivering the commodity to the premises of the buyer, the possession may also be an implied or constructive possession, which takes place by leaving the commodity at one’s disposal and enabling him to deal with it as he wishes. This will be deemed a valid possession, even though the physical possession has not taken place. As for the mode of possession, it may vary from commodity to commodity, according to its nature and pursuant to the different customs prevalent in this behalf."

The time when the risk of the item is passed on from the supplier to the bank, and subsequently from the bank to the customer, must be clearly identified.

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38 *Council of the Islamic Fiqh academy, 2000, p.107*
This is why Shariah scholars normally do not approve Murabahah of natural gas in pipes; the gas company can not say that from ‘this’ point possession of the gas and its risk has been transferred to the bank, and then from the bank to the client. Further, the goods must exist at the time of execution of Murabahah. Sometimes, it happens that the client takes delivery of the goods as agent and uses them in his process of production even before informing the bank and “offer and acceptance”. This creates a Shari’ah objection. Before execution of Murabahah, the bank must ensure that the item exists in its form and for this purpose it is advisable that the bank appoints any person for physical inspection. Further, all ownership related expenses like Takaful until this point need to be paid by the bank. Any loss before that date also belongs to the bank, being the principal owner of the goods.

Execution of Murabahah Stage- Offer and Acceptance

After the customer acquires possession of the goods, as an agent, he should give a possession report and make an offer to purchase the goods acquired by him on the bank’s behalf. The bank will accept the offer and the transaction will be completed. All the terms of the murabahah transaction, such as contract price (cost plus profit), due date or schedule of payments, etc. must be mentioned in the bank’s letter of acceptance. Upon execution of murabahah, the relationship of buyer and seller between the customer and the bank changes into the relationship of debtor and creditor. After this, the bank will not be liable for any harm to the goods.

Having taken delivery of the goods as per the purchase requisition, the customer should confirm that the goods have been examined and are satisfactory in respect of quality and suitability for his use. He should also relieve the bank from any loss or third party liability in respect of the goods sold to him. The AAOIFI Standard recommends that the bank should assign to the customer the
right of recourse to the supplier to obtain compensation for any established defects which would otherwise be recoverable by the bank from the supplier. 39

The complete procedure of Murabahah financing

Incorporating the aspect of agency, too, the procedure of Murabahah could be outlined as follows.

First Phase – Request by Client

Stage 1. The client indicates to the bank the asset required by him, and agrees to purchase it from the bank on Murabahah terms after the bank had purchased it;

Second Phase – Bank Purchases from Supplier

Stage 2. When purchasing the asset directly from the supplier through its own channels without the involvement of the client is not feasible, the bank appoints the client as its agent to purchase the asset and to take possession on behalf of the bank.

Stage 3. The client purchases the asset on behalf of the bank and takes possession, the risk of the asset now being borne by the bank. Payment to the supplier is made by the bank directly to the supplier’s account, without any involvement of the client in handling the funds. The client informs the bank of the completion of purchase on its behalf.

Third Phase – Bank Sells to Client

Stage 4. The client forwards an offer to purchase the asset from the bank on Murabahah terms.

Stage 5. The bank accepts the offer, completing the sale of the asset to the client. With this sale, the ownership of the asset is transferred to the client, who becomes responsible for the risk of the asset there onwards.

39 AAOIFI, 2004-5, Standard on Murabahah, clause 4/9, p.120
Proper execution of each of these stages is vital for the validity of the Murabahah transaction. The most crucial element of this whole procedure is the asset remaining in the risk of the bank during the intervening period between Stage 3 and Stage 5. If this aspect is absent, the transaction is unacceptable in Shari’ah. The above mentioned procedure of the Murabahah financing is a complex transaction where the parties involved have different capacities at different stages.

- At the first stage, the institution and the client promise to sell and buy a commodity in future. Hence, the relation between them is that of a promisor and a promise.

- At the second stage, the relation between the parties is that of a principal and an agent.

- At the third stage, the relation between the institution and the supplier is that of a buyer and seller.

- At the fourth and fifth stage, the institution and the client become buyer and seller, and the sale is concluded on deferred payment basis, thereby have the relation of a debtor and creditor.

It is very important that all these capacities must be properly processed with all their resulting effects, each at its relevant stage, and these different capacities should never be mixed up or confused with each other.

5.2.3 Conditions of Murabahah Financing:

1. Murabahah, as a mode of financing can be used only where the customer requires funds to acquire some merchandise. For example, if he needs funds to buy leather as a raw material for producing shoes, the Bank can sell him the leather on murabahah basis. But if he wants funds for some other purposes, like paying the price of goods already bought, or the bills of electricity or other utilities or for paying the salaries of his staff, murabahah
cannot be concluded, because murabahah entails a real sale of some commodities, and not merely advancing a loan.

2. The financier must have owned the commodity before selling it to his client.

3. The commodity must be in the possession of the financier, whether physical or constructive, and thus take risk responsibility.

4. The best way for murabahah is that the financier himself purchases the commodity and keeps it in his own possession, or buys the commodity through a third person appointed by him as agent, before selling it to the customer. However, in exceptional cases, where direct purchase from the supplier is not practicable for some reason, the customer can be an agent to buy the commodity on behalf of the financier and take its possession as such. Then, he could purchase the commodity from the financier for a deferred price. In the first instance taking possession over the commodity as an agent he is only a trustee, while the ownership with risk bearing responsibility goes to the financier. But once the client purchases the commodity from his financier, the ownership, as well as the risk, is transferred to the client.

5. The financier takes the full responsibility of the risk during intervening period unless the commodity is fully acquired by the customer.

6. The commodity is bought from a third party. The purchase of the commodity from the client himself on 'buy back' agreement is not allowed.

7. In the case of default by the buyer in the payment of price at the due date, the price cannot be increased.  

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Usmani Muhammad Taqi (1999), "An Introduction to Islamic Finance", Idara-e Isha’at-e- Diniyat (P) Ltd. New Delhi, p. 180
5.2.4 Important aspects of Murabahah financing:

Overall Agreement

An overall agreement could be signed between the client and the bank at the inception of the Murabahah facility. This agreement does not signify the sale of any particular asset. Rather, it is an agreement to carry out transactions based on Murabahah on different assets in the future from time to time. The type of the facility, e.g. financing for the purchase of commodities, vehicles etc or financing import purchase, the limit of the facility, and the ratio of profit etc could be stipulated in the agreement.

Supplier Should be a Third Party

Murabahah can be employed only when the client needs to purchase an asset genuinely, either for consumption or for the purpose of trade. This is only possible when the asset is purchased from a third party. In no instance can an asset belonging to the client himself be purchased and then sold back to him on Murabahah. The financial institution should be vigilant that clients do not attempt to abuse Murabahah facilities through such practices.

Sale of Company Shares on Murabahah

As Murabahah is a kind of sale, it could be carried out only with regard to items which are permitted to be sold in the Shari’ah. Company shares that fulfil Islamic requirements could be sold on Murabahah basis. It is essential that the financier owns the shares and has their possession by bearing their risk, before the sale to the client on Murabahah terms.

Currencies cannot be sold on Murabahah

Currencies of different denominations cannot be sold or purchased on Murabahah. Similarly, Bills of Exchange or other documents evidencing debts may not be the subject of Murabahah, because these could be exchanged only at face value.
Agency should be Specific

The agency given to the client by the bank may be for the purchase of a specific quantity of a specific item from a specified supplier, or for purchasing unspecified quantities of a type of commodity from unspecified suppliers. In the latter case, it would form a general agency, authorising the client to make several purchases on behalf of the bank. However, since what the client purchases on behalf of the bank remain at the risk of the bank, it should be ensured that the client exercises proper care in storing the commodities belonging to the bank separately, and duly purchases them from the bank on Murabahah before using them for his own purposes. Since general agency makes monitoring of the client’s activities difficult and also is highly vulnerable to abuse, it should be granted only when necessary. Site visits should be undertaken regularly to ensure compliance.

Exact Cost incurred should be known

It is essential for the validity of Murabahah that the exact cost incurred by the financier is known. If the cost incurred by the financier cannot be precisely established, the relevant asset cannot be sold on Murabahah terms. This is because Murabahah is a sale based on complete transparency with regard to cost, which should be accurately stated in the contract of sale.

Price Difference between Cash and Credit sales

An asset may be sold on credit at a price higher than its usual cash price. The overwhelming majority of Islamic jurists allow this. The only requirement is that the exact credit price should be clearly spelled out in the contract of sale, and may not be left to fluctuate. If the exact price to be paid by the client not fixed in the contract of sale, but is left to be calculated later based on the period of time he takes for full settlement, the sale is not valid in the Shari’ah.
Extension of Period at no Extra Charge

If the client is unable to make full payment of the Murabahah price on the due date and requires an extension of the period, it could be granted without charging anything additional. Any mark-up over and above the agreed Murabahah price could not be added due to the extension, nor could any increase be made in the price of a subsequent Murabahah transaction with the same client in view of the extension given previously.

*Murabahah Outstanding may not be rolled over*

In the case of Murabahah sales involving payment of periodical instalments, if the client finds it difficult to pay the original instalments duly, the remaining instalments may not be rescheduled at any extra payment. If the bank is willing to reschedule the instalments, it should be done without causing any change in the original Murabahah price fixed at the outset. The price may not be increased due to default, as it would tantamount to interest, which is prohibited in the Shari’ah. If the Murabahah price has not been fully settled at the end of the term, it may not be rolled over for a further term.

*Rebate on early Settlement at the Bank’s Discretion*

The client is not entitled to claim any rebate if he is able to complete settlement of the Murabahah outstanding before it falls due. The Murabahah agreement should not incorporate any clause that allows the client to settle early against a discount. However, the financial institution may grant a rebate to the client in this instance at its own discretion, especially in the case of clients who are needy.

The above two points will be discussed in detail in the next chapter.

5.2.5 Market Scenario:

Murabahah as described above could be used to finance the purchase of a variety of assets. It could be employed wherever assets are needed to be
purchased from a third party. From financing consumer items such as washing machines and vehicles, it could be used in corporate financing where building complexes, factories and real estate are to be purchased. Trade financing, both for local purchase as well as import, is widely done on Murabahah based structures. We shall briefly analyse below the procedure adopted in each of these.

**Consumer Financing on Murabahah**

Murabahah is popularly employed for financing the purchase of consumer items such as furniture, computers, vehicles, etc. Here, subsequent to approval of the facility and signing the overall agreement with the client, the client produces a quotation or pro forma invoice from the supplier indicating the price and other details of the item. Usually at this stage, the client makes an undertaking to purchase the asset from the bank, which, as described above, is a unilateral promise made by him, so as to protect the bank from being left with the goods if the client refuses to purchase them.

If the financial institution is satisfied with the genuineness of the request, it purchases the item from the supplier and takes possession using its own agents and means, prior to selling the item to the client on Murabahah. If this is not convenient, it appoints the client as its agent for purchasing the asset on its behalf. The payment is released directly to the supplier without the involvement of the client, through a medium such as a crossed account-payee cheque. After the client purchases the asset and takes possession on behalf of the bank, the bank is informed of this, and the bank preferably verifies the receipt of the goods through its own means. It is highly preferable that the bank requires the client to bring the asset to the bank’s own stores and lets it remain there for at least a day, so as to establish the risk of the bank beyond all doubt.

Subsequently, the bank sells the asset to the client on Murabahah terms through duly accepting a specific offer to purchase forwarded by the client, where the cost of the asset, the profit, the total Murabahah price, the due dates of
payment for the full price or instalments etc are clearly stated. The asset becomes the property of the client only upon the acceptance of the bank, until which the asset remains at the risk of the bank.

The credit period for the settlement of Murabahah price starts from the date the sale to the client is completed, i.e. the date when the bank accepts the offer to purchase forwarded by the client. The period does not start from the day the bank releases funds to the supplier of goods, as goods are purchased by the bank itself initially. The client becomes a debtor to the bank only after he purchases the goods from the bank on Murabahah. Due to this reason, when the profit margin of the Murabahah price is calculated on the basis of the period of credit, the time elapsed prior to the sale to the client in which the goods were in the possession of the bank may not be taken into consideration.

**Murabahah in Trade Finance**

Murabahah could be used for financing the purchase of trade goods, including both raw material as well as stock. The basic features of Murabahah are similar in essence to those of consumer financing. However, the payment periods are usually shorter here. The number of transactions carried out under a single facility is considerably higher than in consumer finance, as the purchase of each consignment constitutes a separate Murabahah transaction. Due to this, ensuring meticulous observance of all necessary conditions becomes a hard task, requiring the sincere intent both of the client as well as the financial institution.

In Trading Murabahah, usually a limit is approved for client, limiting the maximum amount that may become outstanding at a single time through entering in to a number of Murabahah transactions. After the overall agreement, whenever a consignment is to be purchased, the client submits the relevant quotation or pro forma invoice together with an undertaking to purchase, as described above in consumer financing.
It is important to ensure that the client does not apply for Murabahah for goods that have already been purchased by him. This is of especial concern in Murabahah for trading, where consignments are purchased by clients on a daily basis. There is a possibility of an application for Murabahah being made by the client for consignments he had purchased directly from suppliers and had taken delivery, for the purpose of obtaining funds for payment to suppliers. Therefore, verifying the dates of quotations and making enquiry as to whether the goods have already been purchased is essential. Traders sometimes do so on the assumption that goods that have not yet been paid for still belong to the suppliers.

After verification, agency is granted to the client for purchase on behalf of the bank. Each undertaking to purchase requires a separate agency. When the client effects the purchase from the supplier on behalf of the bank and takes possession the goods enter the bank’s risk. In this stage, the client is not allowed to sell or utilise the goods, as they still belong to the bank. If retaining the goods in the bank’s own storing compounds prior to the sale to the client is not feasible, the client should be emphatically required to store them separately, distinct from other merchandise belonging to him, until his purchase from the bank is complete. Site visits should be made periodically to ensure compliance in this respect, as sometimes traders hastily sell such consignments before purchasing them from the bank.

It is essential that the possibility of the funds being channelled to suppliers through the clients is prevented in Trade Murabahah as far as possible. This is for the purpose of ensuring that only genuine transactions take place. If funds are released to the client at the time of agency, this would result in the bank losing its control over the transaction, due to the possibility that the client could use the funds for other purposes, or negotiate credit terms with the supplier for partial or delayed payment. If due to some compelling reason funds are released to the client for payment to suppliers, it should be done only with clients whose sincerity
in carrying out genuine Murabahah transactions is established. It is imperative that properly drawn receipts are obtained from the suppliers in this instance. If the bank knowingly approves Murabahah facilities for fictitious transactions, or the laxity of the system leads to such transactions being carried out, the profit earned may not be permissible.

When the offer to purchase from the bank is forwarded by the client, it should be promptly accepted, as the client may start using the goods for his own purposes only after this. It should not be forgotten that the Murabahah period starts from the date of acceptance. It is best that the bank arranges to complete the sale to the client after a site visit and verification of the goods purchased.

It is possible that after the initial agency is granted and the client effects the purchase on behalf of the bank, the bank may find that the client has reached the limit of his facility. However, as the bank has already become the owner of the goods, it may not refrain from payment to the supplier at this stage.

The documentation in many Murabahah cross-border trades is similar to customary international trade documentation such as freight documents, invoice, certification, Insurance, and so on. These follow the sale agreement (the murabahah) which may be a master agreement for revolving facilities or multiple shipments.”

Murabahah for Import Purchase

A large portion of import transactions are financed by Islamic financial institutions on the basis of Murabahah. Instead of providing an interest based credit facility for imports as done by conventional banks, the Islamic bank is expected to import the consignment in its name first and thereafter sell it to the client on Murabahah. The procedure here is more complex as compared with Murabahah for local trade due the involvement of Letters of Credit, import

documents such as Bills of Lading and Airway Bills as well as foreign exchange conversions. Ensuring the ownership of the bank over the consignment and bearing its risk prior to the sale to the client are points of concern in this procedure. Since there remains an amount of uncertainty over whether the shipping documents being in the name of the bank alone is enough to ensure complete ownership of the bank over the goods, Murabahah is not recommended for import transactions. We shall discuss below how Murabahah is usually practised by Islamic banks in financing import purchases.

An overall agreement for providing Murabahah facilities for import purchases is signed between the bank and the client. When the client wishes to import a consignment of goods, he obtains the Pro Forma Invoice from the supplier and forwards it to the bank together with the undertaking to purchase. The undertaking to purchase only provides an approximate indication of the cost, mark up and the Murabahah price etc, as these are subject to change due to possible differences in shipping documents and exchange rate fluctuations.

The bank issues a Letter of Credit initiating the process of import. Upon receipt of the Letter of Credit through the negotiating bank, the supplier ships the goods and forwards the Bill of Lading, Invoice and other shipping documents to the L/C opening bank. The Bill of Lading and other documents are expected to be in the name of the L/C opening bank, thus purportedly establishing the bank’s ownership over the consignment.

The bank releases the shipping documents to the client by endorsing them in his favour to facilitate port clearance, at the same time effecting a sale transaction to the client through offer and acceptance. From the point of time when the supplier surrenders the goods to the shipping company until the L/C opening bank sells the goods to the client, the goods purportedly are in the ownership of the bank (i.e. the L/C opening bank) and at its risk. If the consignment is damaged or is destroyed during this period, the bank may not
claim any compensation from the client. Even if the consignment is insured through some Islamic arrangement such as Takaful or through conventional insurance, this would not change the party that bears the risk primarily, as insurance only facilitates compensation to the owner if a loss occurs, and does not eliminate possibility of loss.

Import on L/C Sight Terms

In the case of import on L/C sight or D/P (documents against payment) terms where remittance to the supplier is immediate, the sale takes place after the bank had remitted payment, and the amount of local currency spent by the bank for the purpose is known. Therefore, the Murabahah sale could be carried out with ease on the basis of local currency.

Import on D/A Terms

However, when the import is on D/A (documents against acceptance) terms where the supplier himself extends a credit period, payment to the supplier is to be remitted at a future point of time. If the Murabahah sale to the client is planned to be carried out in the local currency, this would require knowledge of the exact amount to be remitted in the local currency, which is not possible due to fluctuation of exchange rates. Therefore, it is not possible to effect a Murabahah sale to the client in local currency in D/A imports. If remittance is to be done in foreign currency, the Murabahah sale also could be carried out in the same currency. On the due date of payment, the client could either settle the Murabahah price in the relevant foreign currency, or pay the equivalent in the local currency based on the exchange rate prevailing on the date of payment.

However, if the client is not willing to carry out the Murabahah purchase in foreign currency due to his apprehension that an unexpected rise in exchange rates could affect him adversely, there remains no possibility of a Murabahah transaction being carried out in this instance. The only option in this situation is to
carry out a Musawamah sale where the bank sells the consignment to the client at a lump-sum price fixed through negotiation. The Musawamah contract does not provide any indication of the cost and profit elements. The sale in this instance could be carried out in the local currency.

However, a sale on Musawamah basis requires the existence of a Musawamah agreement between the bank and the client beforehand, where the nature of the Musawamah transactions to follow is clearly stated. Therefore, if imports are to be done on D/A basis, a Musawamah agreement should be in place, and the import could be financed on the understanding that the consignment will be sold to the client on Musawamah.

In Murabahah for imports, the bank may not charge the client anything other than the Murabahah profit mark-up calculated on cost. No separate charges such as L/C opening fee, handling charges etc could be levied from the client. This is because importing the consignment is expected to be done by the bank itself. These aspects could be kept in view when agreeing on the profit ratio for Murabahah. Apart from the Invoice amount remitted to the supplier, other actual costs incurred by the bank such as custom duty could be included in the cost of the consignment for mark-up calculation, provided the bank undertakes to pay these before the Murabahah sale to the client.

The Murabahah/Musawamah period should start from the date the consignment is sold to the client, i.e. the date the offer to sell forwarded by the bank is accepted by the client, and the shipping documents endorsed in his favour, as this is the point when the client becomes the owner of the goods. The period may not start from the date money is remitted to the supplier, nor could mark-up be calculated for the intervening period if there is any delay in the acceptance by the client.
CHAPTER - VI

EMPIRICAL ANALYSIS OF MURABAHAH
6.1 Introduction:

Islamic banks and financial institutions have become an integral part of the global financial industry. Starting modestly in 1970s through individual trials the Islamic finance industry has developed its own standard, criteria, products and institutions. Now in almost 70 countries the Islamic finance is practiced in some or other form. This includes many European and North American countries which have adopted the Islamic finance practices in their own way, partly to meet the local demand and also to attract overseas funds in their own country.

Geographically Middle East still remains the most active market for Islamic finance products and services followed by South-East Asia and the Indian subcontinent. Innovations in product and services are, however, led by western financial institutions such as Citi Bank, Standard Chartered Bank, Deutsche Bank, ABN Amro etc. All these institutions have their own dedicated Islamic finance wings.

Because of risk free returns comparable to the market rate of interest Murabahah remains the most favored financing tool adopted by Islamic financial institutions worldwide.

Bahrain based General Council of Islamic Banks and Financial Institutions (CIBAFI), which is responsible for collection and dissemination of data related to Islamic financial institutions in the world wide arena has shown in its recent report that financing activities constitute more than 70 per cent of the total assets of all Islamic banks in Gulf Cooperation Council (GCC). Whereas, investing activities forms about 11 per cent of the total assets.

The study covers 2000 - 2006 periods. The data has been collected from the Islamic Financial Service Industry’s report prepared by the General Council for
Islamic Banks and Financial Institution (CIBAFI), Bahrain. Thus, the empirical analysis is based on the last six years of data from the (commercial) Islamic banks of GCC countries.

The compilation of statistical data related to financing and investment activities of Islamic banks is done by using various statistical techniques such as average, weighted average etc. As GCC countries still have a lion’s share and big growth size in Islamic Financial Service Industry (IFSI). Thus, from a statistical point of view, the Islamic banks of GCC countries represent well the Islamic Banking Industry at large.

In this study, an attempt has been made to take into account the financing and investment activities of Islamic banks (IBs) and thereby tried to provide a comparative statistics relating to various modes of financing and investment. In order to provide some empirical evidence on this issue, data has been compiled for the period 2000 - 2006. There is no much perceptible change in the trend of use of these modes over time. However, our time series is not enough to make any judgment about movement over time. The study has computed 5 years’ averages in order to minimize year to year variation. This would provide an idea about the extent of current use of the modes in a better way. One can then compare this with the extent of use of these modes in earlier period from other studies.

Before we study the recent trends of different financing techniques especially Murabahah used by GCC Islamic financial Institutions, it is important to have a brief glance at the growth of Islamic finance in the Gulf region.

6.2 Islamic Finance Growth in the Gulf Region:

It is important to note that Islamic Finance service industry in the Gulf region has grown at a remarkable pace and gained good footing in the short span of few years which is evident from the empirical overview of IFSI in GCC
countries. In the following section we have tried to analyze the case through statistical facts. In brief we can conclude that:

1. Islamic finance surpasses conventional finance in asset, deposit and equity growth.
2. Islamic finance market - share is continuously increasing.
3. Islamic financial assets are witnessing phenomenal growth.

Table-1 (Figure 1-2), provides the growth of Islamic finance in the Gulf region during 2001 - 2006.

**Table-1**

**Islamic Finance Assets, Deposits and Equity in Gulf Region**

(2001-2006)

(US $ Million)

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</thead>
<tbody>
<tr>
<td>Assets</td>
<td>35,271</td>
<td>41,317</td>
<td>50,661</td>
<td>63,309</td>
<td>92,567</td>
<td>133,670</td>
</tr>
<tr>
<td>Deposits</td>
<td>24,765</td>
<td>29,897</td>
<td>36,397</td>
<td>44,185</td>
<td>59,773</td>
<td>77,869</td>
</tr>
<tr>
<td>Equity</td>
<td>5,484</td>
<td>5,919</td>
<td>7,154</td>
<td>10,568</td>
<td>17,019</td>
<td>26,158</td>
</tr>
<tr>
<td>Profit</td>
<td>793</td>
<td>826</td>
<td>1,169</td>
<td>1,727</td>
<td>3,540</td>
<td>5,654</td>
</tr>
</tbody>
</table>

The table-1 (figure 1-2) asserts that both deposits and assets have grown more than 3 times during the last six years. At the same time the growth of equity is 4.7 times with the matching profit. However, the growth of Islamic finance in the Gulf region shows the effective use of capital and the strength and confidence, people have in the system.
Figure-2

Islamic Finance in Gulf Region with respect to Profit & Equity

(2001-2006)
Table-2
Market Share of Islamic Finance (Assets, Deposits, Equity, Profit)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>9.30</td>
<td>10.90</td>
<td>11.60</td>
<td>12.70</td>
<td>15.10</td>
<td>16.70</td>
</tr>
<tr>
<td>Deposits</td>
<td>14.80</td>
<td>15.80</td>
<td>17.20</td>
<td>17.70</td>
<td>19.80</td>
<td>19.80</td>
</tr>
<tr>
<td>Equity</td>
<td>12.50</td>
<td>12.70%</td>
<td>13.90</td>
<td>18.10</td>
<td>21.90</td>
<td>25.90</td>
</tr>
<tr>
<td>Profit</td>
<td>13.10</td>
<td>12.70%</td>
<td>14.60</td>
<td>16.10</td>
<td>19.90</td>
<td>25.10</td>
</tr>
</tbody>
</table>

Source: ibid
Figure-3

Market Share of Islamic Finance (Assets, Deposits, Equity, Profit)
2001-2006

Table-2 (Figure-3) provides the market share of Islamic finance during the period 2001-2006. This is evident from the above table that the market share of deposit remained between 15% – 20%, whereas the equity share and profit doubled in the last 3 years, which is basic concept of the Islamic finance to trade on equity and not on debts.
Table-3


(Percent)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional</td>
<td>-2.30</td>
<td>14.90</td>
<td>12.80</td>
<td>18.50</td>
<td>29.10</td>
</tr>
<tr>
<td>Islamic</td>
<td>17.30</td>
<td>22.60</td>
<td>24.90</td>
<td>45.50</td>
<td>44.80</td>
</tr>
</tbody>
</table>

*Source:* ibid

Table-3 (Figure-4) provides the details about the growth of financial assets in the Gulf region during the period 2000-2006. The above table shows the importance of the growth of Islamic assets over the conventional one which has increased from 17.3 per cent in the year 2002 to 44.8 per cent in the year 2006. Similarly, the table-4 (figure-5) provides the details about the deposit growth in Islamic finance during the period 2002 - 2006. This is depicted from the table that there is also a significant improvement in the deposit growth in the Islamic finance during the above mentioned period.

Table-4


(Percent)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional</td>
<td>10.50</td>
<td>8.60</td>
<td>15.50</td>
<td>16.80</td>
<td>29.10</td>
</tr>
<tr>
<td>Islamic</td>
<td>19.30</td>
<td>20.30</td>
<td>19.90</td>
<td>34.20</td>
<td>29.30</td>
</tr>
</tbody>
</table>

*Source:* ibid.
Figure-4

Assets Growth Break-Up of Conventional & Islamic Banks (2002-2006)
Figure-5
Deposit Growth Break-Up of Conventional & Islamic Banks
(2002-2006)
Table-5 (Figure-6) depicts the equity growth of Islamic finance during the period 2002-2006. The table asserts that in contrast to the conventional mode of finance there is a significant growth in the Islamic finance by more than 8 times during the above mentioned period.

**Table-5**

*Islamic Finance Equity Growth (2002-2006)*

<table>
<thead>
<tr>
<th>Years</th>
<th>Conventional</th>
<th>Islamic</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>5.80</td>
<td>8.40</td>
</tr>
<tr>
<td>2003</td>
<td>8.40</td>
<td>21.00</td>
</tr>
<tr>
<td>2004</td>
<td>10.60</td>
<td>47.50</td>
</tr>
<tr>
<td>2005</td>
<td>31.50</td>
<td>60.90</td>
</tr>
<tr>
<td>2006</td>
<td>22.10</td>
<td>53.90</td>
</tr>
</tbody>
</table>

*Source:* ibid.
Likewise, the table-6 (figure-7) shows the growth of profit in the Islamic finance in the Gulf region during the period 2002 - 2006. It can be depicted from
the table that there is more than 14 times increase in the profit growth of Islamic finance whereas, in the case of conventional mode of finance it has only grown by more than 2 times during the above mentioned period.

Table-6

Profit Growth in Gulf Region (2002 – 2006)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conventional</td>
<td>7.90</td>
<td>19.90</td>
<td>32.20</td>
<td>57.60</td>
<td>18.80</td>
</tr>
<tr>
<td>Islamic</td>
<td>4.20</td>
<td>41.40</td>
<td>47.80</td>
<td>105.00</td>
<td>59.80</td>
</tr>
</tbody>
</table>

Source: ibid.

From the above analysis it is clear that growth in Islamic finance assets, equity and profits are far better than conventional finance. However, the growths in deposits are similar. Whereas, even with equity base, the profits are far ahead from conventional profit growth, which clearly indicates that there are good scopes of development. This is in addition to the fact that Islamic finance industry is an emerging industry in comparison to the conventional one in the Gulf region.
Figure-7

Profit Growth (Conventional & Islamic) in Gulf Region
(2002-2006)

Average Asset Growth Rate (2001-2006) : (30.5%) or (31%)
Current Market’s Asset Share (2006) : 16.7%
Projected Asset Share in (2010) : 27%

If growth rates of Islamic finance in the Gulf region will continue with the same pattern (around 30%) the projection shows that Islamic finance total asset will be 388 billion US $ in 2010 and its market share will be around 27% in 2010.
6.3 Recent Trend of Different Financing & Investment Techniques of Islamic Banks & Break-Up of their Share:

Islamic banks use *mudarabah* on the resource mobilization side, whereas they use a number of financial instruments on the asset side. It is generally noticed that the modes of finance used by Islamic banks are dominated by fixed return modes, especially *Murabahah*. The data for the period 2000 - 2005 is given in the table-7 and the results are summarized in the charts.

**Table-7**

<table>
<thead>
<tr>
<th>Financing Composition of Islamic Banks (2000-2005)</th>
<th>(Percentage)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td><strong>Total Financing / Total Assets</strong></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>73.96</td>
</tr>
<tr>
<td>2001</td>
<td>74.01</td>
</tr>
<tr>
<td>2002</td>
<td>74.34</td>
</tr>
<tr>
<td>2003</td>
<td>74.02</td>
</tr>
<tr>
<td>2004</td>
<td>72.48</td>
</tr>
<tr>
<td>2005</td>
<td>71.14</td>
</tr>
<tr>
<td><strong>Murabaha / Total Assets</strong></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>33.56</td>
</tr>
<tr>
<td>2001</td>
<td>38.38</td>
</tr>
<tr>
<td>2002</td>
<td>41.65</td>
</tr>
<tr>
<td>2003</td>
<td>40.47</td>
</tr>
<tr>
<td>2004</td>
<td>43.22</td>
</tr>
<tr>
<td>2005</td>
<td>49.27</td>
</tr>
<tr>
<td><strong>Bai Al Muajjal / Total Assets</strong></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>28.55</td>
</tr>
<tr>
<td>2001</td>
<td>25.33</td>
</tr>
<tr>
<td>2002</td>
<td>22.37</td>
</tr>
<tr>
<td>2003</td>
<td>20.21</td>
</tr>
<tr>
<td>2004</td>
<td>15.41</td>
</tr>
<tr>
<td>2005</td>
<td>8.64</td>
</tr>
<tr>
<td><strong>Ijarah / Total Assets</strong></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>1.53</td>
</tr>
<tr>
<td>2001</td>
<td>1.24</td>
</tr>
<tr>
<td>2002</td>
<td>2.74</td>
</tr>
<tr>
<td>2003</td>
<td>6.08</td>
</tr>
<tr>
<td>2004</td>
<td>8.04</td>
</tr>
<tr>
<td>2005</td>
<td>8.37</td>
</tr>
<tr>
<td><strong>Istisna / Total Assets</strong></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>6.52</td>
</tr>
<tr>
<td>2001</td>
<td>5.61</td>
</tr>
<tr>
<td>2002</td>
<td>5.11</td>
</tr>
<tr>
<td>2003</td>
<td>3.86</td>
</tr>
<tr>
<td>2004</td>
<td>2.88</td>
</tr>
<tr>
<td>2005</td>
<td>2.19</td>
</tr>
<tr>
<td><strong>Others / Total Assets</strong></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>3.81</td>
</tr>
<tr>
<td>2001</td>
<td>3.44</td>
</tr>
<tr>
<td>2002</td>
<td>2.47</td>
</tr>
<tr>
<td>2003</td>
<td>3.40</td>
</tr>
<tr>
<td>2004</td>
<td>2.93</td>
</tr>
<tr>
<td>2005</td>
<td>2.67</td>
</tr>
</tbody>
</table>

*Source:* Compiled from CIBAFI database concerning IBs of GCC countries (2000-2005)
### Table-8

**Investment Composition of Islamic Banks (2000-2005)**

(Percentage)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Investment / Total Assets</strong></td>
<td>9.65</td>
<td>10.36</td>
<td>10.44</td>
<td>12.23</td>
<td>12.90</td>
<td>14.62</td>
<td>11.70</td>
</tr>
<tr>
<td><strong>Musharakah / Total Assets</strong></td>
<td>0.56</td>
<td>0.89</td>
<td>0.78</td>
<td>0.78</td>
<td>0.85</td>
<td>2.22</td>
<td>1.01</td>
</tr>
<tr>
<td><strong>Mudaraba / Total Assets</strong></td>
<td>0.31</td>
<td>0.69</td>
<td>1.51</td>
<td>1.79</td>
<td>1.95</td>
<td>1.70</td>
<td>1.33</td>
</tr>
<tr>
<td><strong>Invest. in Companies / Total Assets</strong></td>
<td>0.65</td>
<td>0.55</td>
<td>1.69</td>
<td>2.56</td>
<td>2.62</td>
<td>4.55</td>
<td>2.10</td>
</tr>
<tr>
<td><strong>Invest. in Real Estate Properties / Total Assets</strong></td>
<td>2.55</td>
<td>3.03</td>
<td>3.21</td>
<td>2.90</td>
<td>2.51</td>
<td>2.27</td>
<td>2.75</td>
</tr>
<tr>
<td><strong>Invest. in Securities / Total Assets</strong></td>
<td>3.73</td>
<td>4.02</td>
<td>1.89</td>
<td>3.29</td>
<td>4.07</td>
<td>1.12</td>
<td>3.02</td>
</tr>
<tr>
<td><strong>Restricted Inv. Acc / Total Assets</strong></td>
<td>0.77</td>
<td>0.28</td>
<td>0.25</td>
<td>0.37</td>
<td>0.14</td>
<td>0.09</td>
<td>0.32</td>
</tr>
<tr>
<td><strong>Other Investments / Total Assets</strong></td>
<td>1.09</td>
<td>0.90</td>
<td>1.11</td>
<td>0.53</td>
<td>0.75</td>
<td>2.67</td>
<td>1.18</td>
</tr>
</tbody>
</table>

*Source: Compiled from (IFSI First Global Report: Ten Year Analytical Monitoring (2006), GCBAFI, Bahrain.*

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Figure-8
Break-Up of Total Financing & Total Investment share in Total Assets (2000-2005)

Figure-9
Murabaha / Total Assets

207
Figure-19

Restricted Inv. Acc / Total Assets

<table>
<thead>
<tr>
<th>Years &amp; Average</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Share of Restricted Inv. Acc.</td>
<td>0.77</td>
<td>0.28</td>
<td>0.25</td>
<td>0.37</td>
<td>0.14</td>
<td>0.09</td>
<td>0.32</td>
</tr>
</tbody>
</table>

Figure-20

Other Investments / Total Assets

<table>
<thead>
<tr>
<th>Years &amp; Average</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Share of Other Investments</td>
<td>1.09</td>
<td>0.9</td>
<td>1.11</td>
<td>0.53</td>
<td>0.75</td>
<td>2.67</td>
<td>1.18</td>
</tr>
</tbody>
</table>
Table-9

Financing Operations / Total Financing of Islamic Banks
(2000-2005)

(Percentage)

<table>
<thead>
<tr>
<th>Years</th>
<th>Murabaha / Total Financing</th>
<th>Bai</th>
<th>Ijarah</th>
<th>Istsna</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>69.25</td>
<td>12.15</td>
<td>11.77</td>
<td>3.07</td>
<td>3.76</td>
</tr>
<tr>
<td>2003</td>
<td>54.67</td>
<td>27.30</td>
<td>8.21</td>
<td>5.21</td>
<td>4.59</td>
</tr>
<tr>
<td>2002</td>
<td>56.02</td>
<td>30.09</td>
<td>3.68</td>
<td>6.87</td>
<td>3.32</td>
</tr>
<tr>
<td>2001</td>
<td>51.85</td>
<td>34.22</td>
<td>1.67</td>
<td>7.58</td>
<td>4.64</td>
</tr>
<tr>
<td>2000</td>
<td>45.37</td>
<td>38.60</td>
<td>2.06</td>
<td>8.81</td>
<td>5.15</td>
</tr>
<tr>
<td>Average</td>
<td>56.13</td>
<td>27.27</td>
<td>6.41</td>
<td>5.92</td>
<td>4.25</td>
</tr>
</tbody>
</table>

*Source: ibid.*

Figure-21

% Share of Modes of Finance in Total Financing (Year 2005)

- Murabaha: 69%
- Ijarah: 12%
- Istsna: 3%
- Bai: 12%
- Others: 4%
Figure-25

Istisna / Total Financing

<table>
<thead>
<tr>
<th>Year</th>
<th>% Share of Istisna</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>8.81</td>
</tr>
<tr>
<td>2001</td>
<td>7.58</td>
</tr>
<tr>
<td>2002</td>
<td>6.87</td>
</tr>
<tr>
<td>2003</td>
<td>5.21</td>
</tr>
<tr>
<td>2004</td>
<td>3.97</td>
</tr>
<tr>
<td>2005</td>
<td>3.07</td>
</tr>
<tr>
<td>Average</td>
<td>5.92</td>
</tr>
</tbody>
</table>

Years & Average

Figure-26

Other Forms of Finance / Total Financing

<table>
<thead>
<tr>
<th>Year</th>
<th>% Share of Other Unspecified Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>5.15</td>
</tr>
<tr>
<td>2001</td>
<td>4.64</td>
</tr>
<tr>
<td>2002</td>
<td>3.32</td>
</tr>
<tr>
<td>2003</td>
<td>4.59</td>
</tr>
<tr>
<td>2004</td>
<td>4.04</td>
</tr>
<tr>
<td>2005</td>
<td>3.76</td>
</tr>
<tr>
<td>Average</td>
<td>4.25</td>
</tr>
</tbody>
</table>

Average & Years

214
Table-10

Investment Techniques / Total Investment of Islamic Banks
(2000-2005)

<table>
<thead>
<tr>
<th>Years</th>
<th>Musharaka/Total Investment</th>
<th>Mudarabah</th>
<th>Invest. in Companies</th>
<th>Inv. in Real Estate</th>
<th>Invest. in Securities</th>
<th>Restricted Invest. Acc</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>15.17</td>
<td>11.61</td>
<td>31.10</td>
<td>15.53</td>
<td>7.67</td>
<td>0.64</td>
<td>18.28</td>
</tr>
<tr>
<td>2004</td>
<td>6.58</td>
<td>15.11</td>
<td>20.31</td>
<td>19.45</td>
<td>31.55</td>
<td>1.08</td>
<td>5.81</td>
</tr>
<tr>
<td>2002</td>
<td>4.47</td>
<td>14.46</td>
<td>16.18</td>
<td>30.74</td>
<td>18.10</td>
<td>2.39</td>
<td>10.63</td>
</tr>
<tr>
<td>2001</td>
<td>8.59</td>
<td>6.66</td>
<td>5.30</td>
<td>29.24</td>
<td>38.80</td>
<td>2.70</td>
<td>8.68</td>
</tr>
<tr>
<td>2000</td>
<td>5.80</td>
<td>3.21</td>
<td>6.73</td>
<td>26.42</td>
<td>38.65</td>
<td>7.97</td>
<td>11.29</td>
</tr>
<tr>
<td>Average</td>
<td>7.83</td>
<td>10.95</td>
<td>16.76</td>
<td>24.18</td>
<td>26.95</td>
<td>2.97</td>
<td>9.84</td>
</tr>
</tbody>
</table>

Source: ibid.
Figure-27

Investments Break-up (Year 2005)

- Restricted Inv. Acc: 1%
- Inv. in Securities: 8%
- Inv. in Real Estate: 16%
- Musharaka: 15%
- Musharakah / Total Investment
- Mudarabah: 12%
- Inv.in Comp.: 30%

Figure-28

Musharaka / Total Investment

<table>
<thead>
<tr>
<th>Year &amp; Average</th>
<th>% Share of Musharakah in Total Invest.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>5.8</td>
</tr>
<tr>
<td>2001</td>
<td>8.59</td>
</tr>
<tr>
<td>2002</td>
<td>4.47</td>
</tr>
<tr>
<td>2003</td>
<td>6.37</td>
</tr>
<tr>
<td>2004</td>
<td>6.58</td>
</tr>
<tr>
<td>2005</td>
<td>15.17</td>
</tr>
<tr>
<td>Average</td>
<td>7.83</td>
</tr>
</tbody>
</table>
Figure-29

Inv. in Companies / Total Investment

% share of Inv. in Comp.

0 10 20 30 40

2000 2001 2002 2003 2004 2005 Average

Years & Average

Figure-30

Inv. in Companies / Total Investment

% share of Inv. in Comp.

0 10 20 30 40

2000 2001 2002 2003 2004 2005 Average

Years & Average

Figure-31

Inv. in Real Estate / Total Investment

% Share of Inv. in Real Estate

0 10 20 30 40

2000 2001 2002 2003 2004 2005 Average

Years & Average
6.4 Analysis:

It is obvious from the above data that in the financing operation of GCC Islamic banks, Murabahah dominates the financing activities. Almost all the banks have reported to use this financing technique dominantly. Though its extensive use has slightly declined over the period in the case of some Islamic banks. The variation in data seems to point this trend. However, our time series data is not long enough to make any judgment about movement over time e.g. Kuwait Finance House was reported to use Murabahah technique with a reduction.

In the year 2000, Murabahah accounts for about (45%) of total financing. In 2001, its share increased to 51.85 percent. Since then there was a continuous growth except in 2003 when its proportion in total financing came down to 54.67% from 56.02% as in previous year 2002. Then it went to increase to 59.63% and 69.25% in 2004 & 2005 respectively.

During 2000-01, the percentage increase in Murabahah financing was 14.28% whereas during 2001-02, it was 8.04%. But during 2002-03, a decrease of -2.40% was noticed. Then it increased by 9.07% during 2003-04 and reached as high as 16.13% during 2004-05. In short, the percentage change in Murabahah financing remained positive over the periods barring the period 2002-03 that witnessed a negative change.

Thus, during the last 6 years, the percentage change in the use of Murabahah financing operation may be summarized in Table-11 (figure 35):
Table-11


<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-01</td>
<td>14.28</td>
</tr>
<tr>
<td>2001-02</td>
<td>8.04</td>
</tr>
<tr>
<td>2002-03</td>
<td>-2.40</td>
</tr>
<tr>
<td>2003-04</td>
<td>9.07</td>
</tr>
<tr>
<td>2004-05</td>
<td>16.13</td>
</tr>
</tbody>
</table>

*Source: Compiled from CIBAFI Performance Indicators at GCC level (2000-05)*

From the above analysis, the trend & growth of *Murabahah* financing can be depicted in the following figure.

**Figure-35**

Annual Growth Rate of Murabahah in GCC Islamic Banks

2001-2005
It is evident from the above table that during the period 2004-05, Murabaha records highest increase reaching at 16.73% followed by 14.28% increase during 2000-01.

In short, though there is a percentage decline during the period 2002-03, Murabahah has an increasing tendency throughout the years and its proportion in total financing has been more than 50 percent barring one year viz 2000 in which Murabahah accounted 45.37% of total financing.

Bai Muajjal (Sale on deferred payment basis) which is a kin to Bai Murabahah with the difference that unlike Murabahah, price in Muajjal is fixed without disclosing the actual cost of the commodity while a high price is usually charged in both Murabahah and Muajjal. Bai Muajjal financing operation has witnessed continuous proportionate decline barring the year 2005. The data demonstrate that its proportion has continuously come down in each year. In 2001, it accounted for 38.60 percent of all financing operation. Since then, it regularly recorded a continual decrease to the extent that in 2005 its share was only 12.5% which was the lowest and much less in comparison with the proportion that was witnessed in the year 2000. One may observe that there is a percentage decrease of (-68.52%) during the five years i.e. 2000-2005. Thus, the proportion of Bai Muajjal in total financing has significantly declined over the period.

To sum up, Muajjal claimed 38.60 percent of total finance in 2000, and then its share persisted with a constant decline of (34.22%) in 2001, (30.09%) in 2002, (27.30%) in 2003, (21.60%) in 2004, and finally (12.15%) in 2005.

In contrast, the proportion of Ijarah operation remained increasing constantly since the year 2000. Though in 2000, 2001 & 2002 it accounted for less than 5% of total finance but after that its proportion continued to increase with more than 10%. It claimed only (2.06%), (1.67%) and (3.86%) of total finance in the year 2000, 2001, and 2002 respectively, whereas its share increased to (8.21%) in 2003, (11.09%) in 2004, and (11.77%) in 2005. Thus, there was insignificant
increase over the period except during the year 2002-03 in which around 5% increase was recorded. Thus, from the above data one may observe that proportion of *ijarah* in total financial operation has been low over the period.

The same trend was noticed in the case of *istisna* and other financing operations save *Murabahah*. But among them *Ijarah* has done rather well. Its percentage share in total finance provided under other than *Murabahah* technique has hovered around 12% constantly and a consistent increase was noticed over the period whereas in the case of *Muajjal, Istisna* and others, variation and inconsistency with decreasing tendency was observed over the period.

As for *Istisna*, its proportion in total finance came down to 3.07% in 2005 as compared to 8.81% (the highest) in 2002. Thus, we notice a significant decreasing trend over the period. In the year 2000, its proportion in total finance was 8.81% and since then no increase was noticed rather its share continuously declined to (7.58%) in the year 2001, (6.87%) in 2002, (5.21%) in 2003, (3.97%) in 2004 and finally (3.07%) in 2005.

Other unspecified operations whose percentage share in total finance has hovered around 4 per cent. Here a continual decline was also noticed except in the year 2003, when the share of these other financing techniques slightly increased to 4.59% from 3.32% in the previous year. One may observe that this increased percentage share is still lower than the percentage recorded in 2001 & 2002.

In the year 2000, other unspecified techniques accounted for 5.15% of total finance. Since then no increase was noticed and this was the highest one. Their proportion regularly declined to (4.64%) in 2001, (3.32%) in 2002, (4.59%) in 2003, (4.04%) in 2004 and (3.76%) in 2005.

From the above empirical analysis it is clear that *Murabahah* is the most dominating financing technique used by Islamic banks in GCC countries and thus it emerges most popular and favoured form of financing operation amongst them.
At times it seems that some banks use Murabahah as their sole financing technique. Its average percentage share stayed at (56.13%) over the period 2000-05. This mirrors a global trend where Murabahah leads the field with the majority of Islamic banks & financial institutions. The second most popular form of financing used by GCC Islamic banks is Muajjal followed by Ijarah which averaged out at (27.27%) and (6.41%) over the period 2000-05 respectively.

We also observe from Murabahah financing growth rate that there is U-shape change. During 2000-01, the percentage increase was (14.28%) and then (8.04%), (-2.40%), (9.07%) during 2001-02, 2002-03 & 2003-04 respectively. During 2004-06, the growth rate unexpectedly reached as high as (16.13%) which was the ever high increase over the period. One may conclude from this U-shape change in Murabahah operation that the use of this form of financing has gradual decline as its share has been reduced over the past years (i.e. 2000-04) which means that the Islamic banks is swiftly increasing the shares of other financing operations, it can be termed as a good sign but abruptly or phenomenal high percentage increase of (16.13%) during 2004-05 demonstrate otherwise and thus indicating that the banks still have heavy reliance on Murabahah operation (a fixed return mode of finance).
CHAPTER - VII

ISSUES & PROBLEMS OF MURABAHAH FINANCING
ISSUES AND PROBLEMS OF MURABAHAH FINANCING

As described in preceding chapter, Murabahah is not the ideal mode advocated by jurists for financing purposes. It is essentially a trading instrument that has been adapted for financing. Thus, several major problems and concerns have arisen in the use of Murabahah for financing purposes, some of which are discussed below with brevity.

7.1 The Difference in Pricing for Cash and Credit Sales:

Since, Murabahah is usually used on differed payment basis i.e. the seller buys the commodity on cash and sells it on credit, while deciding the price, he also considers the period of payment. The longer the maturity of the Murabahah payment, the higher the price. Thus the price in Murabahah contract is normally higher than the market price. Now the question arises as to whether price of credit sale may be higher than that of cash sale or not. Opinions differ. Some approve and others disapprove.¹

Those who do not hold that price of a commodity in cash & credit contract may differ, argue that the increase of price in a credit sale being in consideration of the time given to the buyer, should be regarded tantamount to the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis they argue that the murabahah contracts are no longer different in essence from the interest bearing loans.

This argument was countered by the opponent who see no harm if the price of credit sale is fixed at more than the cash price. M. Taqi Usmani has tried to convincingly counter the stand point of the former and argue that considering the

¹ One may find a detailed discussion on the subject in legal discourses, M. Taqi Usmani has briefly touched upon some details in this regard. He has summed up the arguments of both parties on the subject. See "An introduction to Islamic Finance", op. cit. pp. 111-118
increased price in credit sale as analogous to interest does not seem to hold good. He also sees that a seller may consider many other good reasons for increasing the price. While arguing, he first tries to explain the difference between money and commodity and clear out the misunderstanding arose from the notion of treating money and commodity the same. He has put forth many points as to how money is different from commodity.\(^2\) He strongly argues that Shari'ah has treated money and commodity differently. Hence regarding the money and commodity as same owing to outward appearance of some resemblance to each other and thus arguing the case is unjust. The summation of his argument in this regard is as follows:

- In modern commercial transaction, the difference between money and commodity is of no concern. Both are treated at par and thus can be traded in. One can sell one dollar for two dollars on the spot as well as on credit, just as he can sell a commodity in this away. But the Shari'ah law does not subscribe to this theory.

- Money has no intrinsic utility. Whereas, the commodities have intrinsic utility.

- The commodities can be of different qualities, money, on the other hand, has no such quality except that it is a measure of value or a medium of exchange.

- In commodities, the contract (sale and purchase) is effected on a particular commodity or, at least, on the commodities having particular specifications. Money, on the contrary, cannot be pin-pointed in a transaction of exchange.

He, then argue that in view of these obvious differences between money and commodity, if there is increased price in credit sale, it can not be tantamount to interest. As in the case of currency note which has no intrinsic utility nor a different quality (recognized legally), there would be no excess on either side, and

\(^2\) For more detail, see Usmani, "An introduction to Islamic Finance", op. cit. p. 111-112
hence not allowed in Shari‘ah. The case of the normal commodities is different. Since they have intrinsic utility and have different qualities, the owner is at liberty to sell them at whatever price he wants, subject to the forces of supply and demand. The supplier may even sell his commodity at a higher price in a cash transaction to different buyers and so does he in a credit sale, subject only to the conditions and ethics of sale.

Usmani, countering to another argument of opponent that the increase of price in a cash transaction is not based on the deferred payment, therefore it is permissible while in a sale based on deferred payment, the increase is purely against time which makes it analogous to interest, he makes the point clear thus: “Any excess amount charged against late payment is riba only where the subject matter is money on both sides. But if a commodity is sold in exchange of money, the seller, when fixing the price, may take into consideration different factors, including the time of payment.” For example:

(a) The seller’s shop is nearer to the buyer who does not want to go to the market which is not so near.

(b) The seller is more trust-worthy for the purchaser than others, and the purchaser has more confidence in him that he will give him the required thing without any defect.

(c) The seller gives him priority in selling commodities having more demand.

(d) The atmosphere of the shop of the seller is cleaner and more comfortable than other shops,

(e) The seller is more courteous in his dealings than others.

Thus, these and similar other considerations may have role in charging a higher price from the buyer. He further, make out the strong case that whatever the

\[\text{ibid.}\]
reason of increase, the whole price is against a commodity and not against money. Once the price is fixed, it relates to the commodity, and not to the time. Hence, if the customer fails to pay at the fixed time, the price will remain the same and can never be increased by the seller. Had it been against time, it might have been increased, if the seller allows him more time after the maturity.  

To argue in another way, any excess in a credit transaction (of money in exchange of money) is against nothing but time because money can only be traded in at par value. For this very reason, if the debtor is allowed more time, some more money is claimed. Conversely, in a credit sale of a commodity, time, at times, may act as an ancillary factor to determine the price but it is fixed for commodity, not for time as once the price is fixed, there can be no increase.

To sum up, when money is exchanged for money, no excess is allowed, neither in cash transaction, nor in credit, but where a commodity is sold for money, the price agreed upon by the parties may be higher than the market price, both in cash and credit transactions.  

This is corroborated by the stand points of majority of the jurists. They are of the view that the price may differ in case of both cash and credit transaction and seller may fix the different price for cash and credit sales and the latter may be higher than the former, subject to the condition that at the time of actual sale, one of the two options must be determined, leaving no ambiguity in the nature of the transaction.

The Council of Islamic Fiqh Academy of Jeddah which is the largest representative body of the Shariah scholars and is represented by all the Muslim countries, in its 6th convention held at Jeddah, KSA on 14-20 March 1990, has discussed the issue and resolved the following:

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4 Usmani, op. cit. pp 113-118
5 ibid.
First: It is permissible to fix an increased price for a commodity sold on deferred payment, as compared to its cash price. It is also permissible to mention different prices for cash and deferred sales. Even the deferred prices can vary according to the different periods specified for payment, and such variance can be expressly disclosed by the seller to the customer. But the sale cannot take place until the parties agree to contract a particular mode of payment and specify whether the payment is in cash or deferred. Therefore, if the sale takes place without specifying a single particular mode of payment, leaving it uncertain whether the buyer shall pay in cash or in installments, the sale is not valid according to Shari'a.

Second: It is not permissible, in installments sale, to fix the spot price on cash basis, then to charge interest expressly tied with different periods, as separate from the price of the commodity, no matter whether the parties have agreed on a particular rate of interest or have left it to the current market rate.

Third: If the buyer/debtor delays the payment of installments after the specified date, it is not permissible to charge any amount in addition to his principal liability, whether it is made a pre-condition in the contract or it is claimed without a previous agreement, because it is "Riba", hence prohibited in Shari'a.

Fourth: It is prohibited (Haram) for a solvent debtor to delay the payment of the installments from their due dates. However, it is not permissible in Shari'a to impose a compensation in case he delays the payment.

Fifth: It is permissible for the seller to impose a condition in the sale agreement that if the debtor/buyer delays the payment of some installments, all the remaining installments shall be due at once before their agreed date. This condition may be a valid condition, provided that the buyer had agreed to it when entering into the sale agreement.
Sixth: The seller has no right to secure the ownership (of the sold commodity) after the sale has taken place. However, it is permissible for him to impose a condition that the buyer shall mortgage the sold commodity with the seller to secure his right of receiving the deferred installments of the price.6

7.2 Rebate in Case of Early Payment:

Sometimes the debtors want to pay early to get discounts as in the case of conventional banking. Can an Islamic bank allow rebate on early payment of Murabaha? This issue has been examined by the classical jurists in detail, and it was concluded that since Murabaha represents the sale of a specific commodity - the price of which is a settled issue - there can be no rebate or discount on voluntary early payment by the buyer. The issue is known in the Islamic legal literature as "Da' wa ta'ajjal" (Give discount and receive soon).

Some earlier jurists (from Shafi'is, Hanbalis and 'Ibadis) have held to its permissibility, but the majority of the Muslim jurists, including the four schools of Islamic jurisprudence esp. Malikis sternly disapprove it and do not allow remission (for earlier payment in murabaha operation by banks). Some jurists opine that if the early payment is tied to a discount, it is not permissible. However, if the rebate is not an attraction for pre-payment and is not taken to be a condition for earlier payment and the bank gives an allowance voluntarily, it may be permissible under Sharia.7

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6 Resolution no (51/2/6) concerning 'sales on installments' by The Council of the Islamic Fiqh Academy, Jeddah, in its sixth session held in Jeddah, Kingdom of Saudi Arabia, from 17 to 23 Sha'ban 1410H (corresponding to 14 - 20 March, 1990)

7 According to Usmani, M.T., """The view of those who allow this arrangement is based on a hadith in which Abdullah ibn 'Abbas is reported to have said that when the Jews belonging to the tribe of Banu Nadir were banished from Madinah some people came to the Holy Prophet (PBUH) and said, "You have ordered them to been expelled, but some people owe them some debts which have not matured". Thereupon the Holy Prophet (PBUH) said to them (i.e., the Jews who were the creditors): "Give discount and receive (your debts) soon." The majority of the Muslim jurists, however, do not accept this hadith as authentic. Even Imam al-Baihaqi, who has reported this hadith in his book, has expressly admitted that this is a weak narration. Even if the hadith is held to be authentic, the exile of Banu Nadir was in the second year after hijrah, when riba was not yet prohibited. Moreover, al-Waqidi has mentioned that Banu Nadir used to advance usurious loans.

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What needs to be understood is that the customer cannot claim it as his right and hence it cannot be made a condition of the Murabaha agreement. Furthermore, the bank will have the sole discretion to decide what remission should be offered to a client in this situation.

The IOC Fiqh Academy, the Shariat Appellate Bench of the Supreme Court of Pakistan, Shariah committee of Islamic banks in the Middle East and shariah scholar in general consider that it would be similar to interest-based installments sale techniques. The AAOIFI's shariah standard on Murabaha, however, allows a rebate if it is not already stipulated in the Murabaha contract. Therefore, if the customer makes early payment and there is no commitment from the bank in respect of any discount in the price of Murabaha, the bank may have discretion in allowing the rebate especially if the client is needy. Thus Islamic banks may give somebody a rebate but the contemporary scholar strongly see that it should not made a practice and any such case should be decided on merit in consultation with shariah advisor.

Therefore, the arrangement allowed by the Holy Prophet was that the creditors forego the interest and the debtors pay the principal sooner. Al-Waqidi has narrated that Sallam b. Abi Huqaiq, a Jew of Banu Nadir, had advanced eighty dinars to Usaid Ibn Hudayr payable after one year with an addition of 40 dinars. Thus, Usaid owed him 120 dinars after one year. After this arrangement, he paid the principal amount of 80 dinars and Sallam withdrew fi-om the rest. For these reasons, the majority of the jurists hold that if the earlier payment is conditioned with discount, it is not permissible. See the details in his book: An Introduction to Islamic Finance, p....)

According to Usmani, “The Islamic Fiqh Academy, Jeddah in its annual session too has taken the same view meaning that in a murabahah transaction effected by an Islamic bank or financial institution, no such rebate can be stipulated in the agreement, nor can the client claim it as his right. However, if the bank or a financial institution gives him a rebate on its own, it is not objectionable, especially where the client is a needy person. For example, if a poor farmer has purchased a tractor or agricultural inputs on the basis of murabahah, the bank should give him a voluntary discount.” ibid.

AAOIFI, 2004-5a, p. 132

7.3 Rollover in Murabahah:

“Rollover” in Murabahah means booking another Murabahah against receivables of any previous Murabahah, payment in respect of which has not been made by the client.\(^{11}\)

Can there be a roll-over in Murabahah?

Some people misconstrue that as in conventional banks a Murabahah amount can also be rolled over by adding the profit for the extended period if the buyer agrees to bear the same.

According to contemporary shari’ah scholars, Murabahah contract cannot be rolled over for a further period. Since it belongs to a specific commodity which has already been sold and hence cannot be sold twice. Muhammad Ayub\(^ {12} \) opines thus:

“This is explicit Riba, as the bank is not entitled to any amount over and above the debt created in Murabahah transaction, as a result of which ownership of the sold goods had already been transferred to the client. Now the bank has no right of re-pricing. Re-scheduling is allowed, but re-pricing and, therefore, rollover is not allowed.

The bank, at its discretion, can reschedule the payment without any increase in the original receivable. Any amount taken from the client on account of the late payment, as per his undertaking in the Murabahah agreement, would go to the

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\(^{11}\) Ayub, Muhammad G. (2007), op. cit, p. 232

\(^{12}\) MUHAMMAD AYUB is Director Training, Development and Shariah Aspects at Institute of Islamic Banking & Insurance (IIBI), London. Formerly, he was with the State Bank of Pakistan (central bank) where he headed the Islamic Economics Division and Shariah Compliance Division as Senior Joint Director in the Research and Islamic Banking Departments. He also served as Head of Islamic Banking at National Institute of Banking and Finance (NIBAF), the training wing of SBP. Besides contributing a large amount of material, he has been serving as Master Trainer on theory and practice of Islamic finance. For last two decades, he has been involved in R&D for facilitating I.B. Industry, Products Development, IB Prudential regulations, Risk management and Shariah related controls and audit of Islamic banking institutions.
charity account. However, there is the possibility of a fresh Murabahah facility through the sale of new goods.”

It should be noted here that Murabahah is not a loan transaction but the sale of a commodity, the payment of which is deferred to a specific date. Once the commodity is sold, its ownership is passed on to the client (buyer), irrespective of the terms of payment being sight or deferred.

Hence it is no more the property of the seller. As such how can the bank sell a commodity a second time around which is not owned by it any more?

Usmani opines in this way:

“Murabahah transaction cannot be rolled over for a further period. In an interest-based financing, if a customer cannot pay at the due date for any reason, s/he may request the bank to extend the facility for another term. If the bank agrees, the facility is rolled over on the terms and conditions mutually agreed at that point of time, whereby the newly agreed rate of interest is applied to the new term. It actually means that another loan of the same amount is re-advanced to the borrower.

Suhail Zubairi, Special Gulf News

Usmani express disapproval in this way, “Some Islamic banks or financial institutions, who misunderstood the concept of murabahah and took it as merely a mode of financing analogous to an interest-based loan, started using the concept of roll-over to murabahah also. If the client requests them to extend the maturity date of murabahah, they roll it over and extend the period of payment on an additional mark-up charged from the client which practically means that another separate murabahah is booked on the same commodity. This practice is totally against the well-settled principles of Shariah. It should be clearly understood that murabahah is not a loan. It is the sale of a commodity the price of which is deferred to a specific date. Once the commodity is sold, its ownership is passed on to the client. It is no more a property of the seller. What the seller can legitimately claim is the agreed price which has become a debt payable by the buyer. Therefore, there is no question of effecting another sale on the same commodity between the same parties. The roll-over in murabahah is nothing but interest pure and simple because it is an agreement to charge an additional amount on the debt created by the murabahah sale.” See An Introduction to Islamic finance; p.

Usmani, M. Taqi, op. cit. p
7.4 Rescheduling for Additional Payment:

Some times customer is not able to pay according to the dates agreed upon in the murabahah agreement, so he requests the seller/ the bank for rescheduling the installments. At times, rescheduling of installments is seen as a way out in the face of default. In conventional banking, loan rescheduling is accompanied by additional interest charge for the timing differences. This is not possible in murabahah payments. In Murabahah such rescheduling is not allowed as no additional amount can be charged for the same. But if the installments are rescheduled, no additional amount can be charged for rescheduling. The amount of the murabaha price will remains unchanged.¹⁷ Some banks attempt to circumvent this by changing the unit of currency. Needless to say, this is not permissible.¹⁸ They proposed to reschedule the murabahah price in other than a currency in which initial transaction effected. Usmani Says:

"Some Islamic banks proposed to reschedule the murabahah price in a hard currency different from the one in which the original sale took place. This was proposed to compensate the bank through appreciation of the value of the hard currency. Since this benefit was proposed to be drawn from rescheduling, it is not permissible. Rescheduling must always be on the basis of the same amount in the same currency. At the time of payment however, the purchaser may pay with the consent of the seller, in a different currency on the basis of the exchange rate of that day (i.e. the day of payment) and not the rate of the date of transaction."¹⁹

¹⁷ Usmani, op. cit. p.
¹⁹ Usmani, op. cit. p
7.5 Murabahah Financing with Tawarruq\(^2\) (commodity Murabahah\(^2\)):

Islamic financial institutions made a proposal to offer deposit product and financing based on the concept of tawarruq or commodity murabahah\(^2\).

Tawarruq involves buying something on deferred credit and selling the item on to get cash. As a result, cash has been obtained without taking out a loan and paying interest.

Tawarruq is actually a sale contract whereby a buyer buys an asset from a seller with deferred payment and then sells the asset to the third party on cash with a price lesser than the deferred price, for the purpose of obtaining cash.\(^2\)

This transaction is called tawarruq because when the customer buys the asset with deferred payment, he has no intention of using or getting benefit from it, but merely to facilitate him to obtain cash or attain liquidity (waraqah maliyyah).

Thus, the aim of contract, for the buyer, is to obtain money or cash, so he does not buy the commodity to use it for any purpose. The contract includes two transactions: the first, the purchase of the commodity for a deferred payment, and

\(^{20}\) Tawarruq means a sale contract in which the buyer obtains merchandise on credit and then sells it for cash. Thus, in this contract, the seller sells a commodity which is normally under his ownership and belongs to his business, to the buyer for deferred payment, and the seller delivers the commodity to the buyer to be under his full possession and responsibility. Then, after the commodity is received by the buyer, he sells it to a third party, who is not the seller, for immediate payment. Later, Tawarruq got developed into other forms.

\(^{21}\) In commodity Murabahah the profits are made on the buying and selling of a commodity, usually metal, such as copper, aluminum, or lead. A buys the metal at the spot price, or the current price, then sells the metal to B on a deferred payment basis, say for three months, at the spot price plus a mark-up or profit for doing so. B will then immediately sell the metal to a broker or another institution for the spot price. In this way, A makes a profit from the mark-up, while B raises funds for its investments.

\(^{22}\) Commodity murabahah is one of the most popular techniques used to manage short-term liquidity in the Gulf region (especially Saudi Arabia and United Arab Emirates) (El-Gamal, 2006, Islamic Finance: Law, Economics and Practice.). It is based on commodities traded on the London Metal Exchange (LME) on a spot basis with 100 per cent payment of the purchase price, then selling the purchased commodities to a third party on a Murabahah (cost-plus sale) basis for a deferred payment with a maturity from one week to six months, and with spot delivery of the sold commodities.

\(^{23}\) This definition is accepted by the OIC Fiqh Academy in their deliberation on the issue on 1st November 1998 (11 Rejab 1419H). See also (Wizarah al-Awqaf wa al-Syu’un al-Islamiah, (2005) Al-Mawsu’ah al-Fiqhiyyah, vol. 14, p. 147.)
then the second, the sale of the same product for immediate payment; the first price normally is more expensive than the second price. In addition, there are more than two parties involved in the contract; the first party is the seller who sells the commodity in a deferred sale, the second party is the first buyer, and the last party is the second buyer who buys the commodity from the first buyer for an immediate payment. The first buyer who buys the commodity by deferred payment is the seller in the second transaction which is for immediate payment.\footnote{SALAH AL-SHALHOOB, (2007) ‘Organised Tawarruq in Islamic Law: A Study of Organised Tawarruq as Practiced in the Financial Institutions in Saudi Arabia.’ P. 7: https://eprints.kfupm.edu.sa/14894/1/organised_tawarruq_in_Islamic_law_(Conf_23_Apr_2007).pdf}

Discussion among the majority of classical jurists on tawarruq was done simultaneously with bai‘ al-‘inah. They do not differentiate the discussion on tawarruq and bai‘ al-‘inah; except the scholars of Hanbalis who have distinguished it. In the main, tawarruq and bai‘ al-‘inah are similar in terms of its objective to obtain cash through the selling and buying transactions, but they are different in two aspects.

Firstly, bai‘ al-‘inah does not involve third party as purchaser of the object of sale (asset/commodity), while tawarruq involves third party. Secondly, the sale item in bai‘ al-‘inah is returned back to the original owner, whereas in tawarruq, there is no such condition.

7.5.1 The Ruling of Tawarruq

Most of the Muslim scholars have cited the same authorities on the legality or permissibility of tawarruq and bai‘ al-‘inah, looking into the similarities of both transactions. Only the scholars of Hanbalites have stated the terminology of tawarruq and deliberate it separately.
7.5.2 Those Who Reject Tawarruq

There is a view from Imam Ahmad ibn Hanbal which states that tawarruq is prohibited (haram). Another view from Imam Muhammad bin Hasan al-Shaibani a Hanafites held that tawarruq is discouraged (makruh). Imam Ibn Taimiyyah has considered tawarruq as an exceptional dealing which is permitted in the case of necessity (dharurat), where the person is really in need of cash. The authorities used by those who reject tawarruq are as follows:

Hadith: “Ali has stated: Ibn Musa has said that this is what we have been told by Hushaim. The Prophet PBUH has said: A time is certainly coming to mankind when people will bite each other and a rich man will hold fast what he has in his possession (his property), though he was not commanded for that. Allah the Almighty said: (and do not forget liberality between yourselves), and then those who are forced will contract sale while the Prophet PBUH has forbidden forced contract, one which involves some uncertainty and the sale of fruit before it is ripe.”

Imam Ahmad ibn Hanbal has envisaged that $bai$-$inah$ is allowed in the case of necessity when people are really in need of cash and the rich are reluctant to lend it to them. As such, the needy people who are in need of money will perform $bai$-$inah$ and tawarruq. With the transactions, they will be getting cash by putting higher price on the deferred payment against the lower price in cash.

Interestingly, past jurists from Malikis and Hanbalis schools who categorically disallowed and nullified $bay$-$al$-$inah$ transaction, do not actually reject tawarruq outright. Instead, they were inclined to allow it mainly arguing that the presumption that the parties intended to circumvent the prohibition of riba was quite remote in tawarruq due to its tri-partite nature (El-Gamal, 2006, op. cit.). However, two prominent Hanbali jurists, namely Ibn Taimiyah and his disciple Ibn Qayyim Al-Jawziyyah departed from the majority Hanbali school’s approval of tawarruq. They disallowed tawarruq and dismissed it as a legal trick (hilah) similar with $bay$-$al$-$inah$ (Al-Zuhayli, 1989, Al-Fiqh Al-Islami Wa Adillatuhu (Third ed.), Beirut: Dar al-Firk.)
7.5.3 Those Who Accept Tawarruq

Those who have approved *tawaruuq* esp. the Hanbalite viewed that it is a permissible mode of transaction. Their view is supported by the following arguments:

- *Al-Quran*: “Allah has permitted sale and prohibited riba”

The permissibility of *tawarruq* may be deduced from the general meaning of the verse and considered an allowed sale transaction. Such a deal may be exercised with the intention of getting cash with the knowledge of all the parties concerned or without the knowledge of the parties who have sold the object with deferred payment. This transaction may also be employed because of need and necessity or because it is an accepted mechanism of commercial dealing, which is normally practiced in the society or institution. One of the arguments put forward to justify the case is their adoption of Shafi‘i’s view in legalising *tawarruq* i.e. public interest consideration (*maslahah*).

- **The Recent Fatwa**

Dr Rafik Yunus al-Misri has stated that some of the Muslim scholars have approved the *tawarruq* without any justification in details on its permissibility. In

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29 The reference to the details who have allowed *tawarruq* can be seen in the Mawsu‘ah al-Fiqhiyyah, vol. 14, p. 147.
30 Surah al-Baqarah : 275.
32 *Maslahah* is one of the juristic devices that have always been used in Islamic legal theory to promote public benefit and prevent social evils or corruption. The plural of the Arabic word *maslahah* is *masalih* which means welfare, interest or benefit. Literally, *maslahah* is defined as seeking the benefit and repelling harm. The words *maslahah* and *manfa‘ah* are treated as synonyms. *Manfa‘ah* (benefit or utility), however, is not technical meaning of *maslahah*. What Muslim jurists mean by *maslahah* is the seeking of benefit and the repelling of harm as directed by the Lawgiver or *Shari‘ah*. Amongst the major school of Islamic jurisprudence, Imam Malik is known to be the leading proponent of upholding *maslahah* as one of the sources of *Shari‘ah*. He uses the term “*al-masalih al-mursalah*” to connote interests which have not been covered by other sources of *Shari‘ah*. On the other hand, the majority of other jurists reject it as a source of *Shari‘ah* though, they practiced it without theoretically admitting its authority as an independent source of the *Shari‘ah*. However, Al-Ghazali (who is from the Shafi‘i school), uses the term *istislah* (seeking the better rule for public interest) but never claim it as the fifth source of *Shari‘ah*. He also restricts its application to situation which is deemed to be of necessary to serve the interest of the public. For detailed discussion, refer to (Al-Khoyat, 2000, *Maqasid Al-Shariah Wa Usuul Al-Fiqh*; Nyazee, 2000, *Islamic Jurisprudence (Usul al-Fiqh)*).
his view, the ruling of *tawarruq* may vary depending on the following circumstances:

i. If all of the three parties involved have known that the main objective of the customer for entering the *tawarruq* transaction is to obtain the cash money, then all of them are sinful.

ii. If two of the parties have known that the seller has used the transaction for getting the cash, both of them are sinful. However, if they do not know the real intention of the seller, then they are not sinful.

iii. A person is allowed to do *tawarruq* in the case of necessity.\(^{33}\)

    However, *Majma' al-Fiqh al-Islami* in its 15th meeting\(^{34}\) has permitted the practice of *tawarruq*. The decision on the permissibility of *tawarruq* was actually arrived on the basis that the *tawarruq* is executed without prior arrangement of the parties involved. Though, in its 17th meeting,\(^{35}\) the decision made was to prohibit the practice of *tawarruq*.\(^{36}\)

    The latest decision is applicable to the practice of *tawarruq* that are adopted by the financial institutions which is known as *al-tawarruq al-munazzam* or *al-tawarruq al-masrafi* (*pre arranged tawarruq*).\(^{37}\) The justification for rejecting such *tawarruq* is that its *modus operandi* resembles *bai'-`inah*; whereby the financial

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\(^{33}\) Dr. Rafik Yunus al-Misri, *Bai' al-Taqsit Tahlil Fiqhi wa Iqtisadi*, p. 120.

\(^{34}\) in the Circle 15th, Makka, 1998

\(^{35}\) In the Circle 19th, Makka, 2003

\(^{36}\) Islamic Fiqh Academy has two resolution relevant to this issue the first resolution does not prohibit traditional *tawarruq* and the second resolution prohibits *organized tawarruq*, the reason for that is the differences between the two contracts. However, the Council in its 51st meeting held on 28th July 2005 / 21st Jamadi Il Akhir 1426, resolved that deposit product and financing based on the concept of *tawarruq* which is known as commodity murabahah is permissible. For more details see al-Qiri, al-Tawarruq *Kama Tujrih al-Masrafi al-Islamiyya*, MBFM, 1426, n. 67, pp. 38-41; Al-Mushaiqih, al-Tawarruq al-Masjirif, 1425H, MOQ, v. 18, no. 30, pp. 187-188. As cited by SALAH AL-SHALHOOB op. cit.

\(^{37}\) There are, however, differences between the traditional *tawarruq* and organised *tawarruq* (*al-tawarruq al-munazzam*). In the traditional *tawarruq*, the first party who sells the commodity in a deferred sale does not know that the second party who buys the commodity in a deferred sale plans to sell the commodity to obtain cash, or at least the seller does not arrange the second transaction. As a result, the only one who is involved in both transactions, whether directly or indirectly is the first buyer. On the other hand, the financial institution arranges the contract from the beginning by offering the commodity to the client until the end by crediting the price in the account of the client.
institution who is acting as an agent to the customer (*mustawriq*) who needs the cash is selling the asset commodity which was initially purchased from the same institution to the third party.

This practice seems to be resemble to the practice of *baiʾ-ʾinah* (which is prohibited in Islamic law according to the majority scholars) and does not represent the true *tawarruq* which has been regarded as accepted by the jurists.

Secondly, this kind of contract, in many cases, does not reflect the concept of possession in Islamic law. Thirdly, the reality of this type of contract is to finance the client (*al-mustawriq*) who applies for some money and to charge him extra; the financial institute arranges the procedure of the contract, by obtaining the commodity and selling it in the market on behalf of the client, to achieve this purpose. However, that is not the real form of *tawarruq* which has been indicated in the traditional fiqh, and previously Okayed by the *Islamic Fiqh Academy*, Jeddah.38

On the other hand, the Shariah Supervisory Council of ABC Islamic Bank in their decision has approved *tawarruq* for liquidity purposes.39

Furthermore, despite the objection by many quarters towards *tawarruq munazzam* (organised *tawarruq*), such practice has also been approved by a few contemporary scholars such as the leading Saudi jurist, Syeikh Abdullah Sulaiman al-Mani’, Dr. Musa Adam Isa, Dr. Usamah Bahr and Dr Sulaiman Nasir al-Ulwan.40

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Dr. Asyraf Wajdi Dusuki opines in his paper: 41

“Despite the criticisms towards tawarruq, the product has been generally perceived and received more favourable and positive than bay’ al-‘inah transaction, at least by a majority of past and present scholars. Unlike bay’ al-‘inah which is widely used in Malaysia and Brunei, tawarruq-based transaction has been spreading quite rapidly in GCC region especially Saudi Arabia, Bahrain and UAE. This development shows the concerns and recognition by some of the jurists globally of the need to find alternatives for solving the inherent problem of liquidity risk faced by Islamic financial institutions due to their balance sheet structure and nature.”

7.6 Murabahah Securitization:

Can Murabaha receivables be securitized? The majority of contemporary shariah scholars disapprove this arrangement but some people hold the view that a part of Murabaha receivables may be securitized. The noted contemporary Shariah scholar, Usmani, M. Taqi says:

“Murabahah is a transaction which cannot be securitized for creating a negotiable instrument to be sold and purchased in secondary market. The reason is obvious. If the purchaser/client in a murabahah transaction signs a paper to evidence his indebtedness towards the seller/financier, the paper will represent a monetary debt receivable from him. In other words, it represents money payable by him. Therefore transfer of this paper to a third party will mean transfer of money. It has already been explained that where money is exchanged for money (in the same currency) the transfer must be at par value. It cannot be sold or purchased at a lower or a higher price. Therefore, the paper representing a monetary obligation arising out of a murabahah transaction cannot create a

negotiable instrument. If the paper is transferred, it must be at par value. However, if there is a mixed portfolio consisting of a number of transactions like musharakah, leasing and murabahah, then this portfolio may issue negotiable certificates subject to certain conditions more fully discussed in the chapter of "Islamic Funds".^[42]

Muhammad Ayyub comments on ‘Securitization on the basis of Murabahah’ thus:

“Any paper representing a monetary right or obligation arising out of a credit sale transaction by banks can not create a negotiable instrument. Therefore, Murabahah receivables can not be securitized for creating negotiable Sukuk to be traded in the secondary market. The purchaser on credit in a Murabahah transaction signs a note or paper to evidence his indebtedness towards the seller. That paper represents a debt receivables by the seller. Transfer of this paper to a third party must be at par value. ..........

A mixed portfolio consisting of a number of transactions, including Murabahah, may issue negotiable certificates subject to certain conditions. For this purpose, the pool of the assets should consists of Ijarah or other fixed assets valuing more than 50% of its worth.”^[43]

Dr. M.N. siddiqi examines this issue citing the opposing views & arguments as follows:

“The juristic objection to sale of debts resulting from murabahah, etc. is the same as in case of selling a debt created by a money loan. If I buy for 90 an IOU worth 100 after a year, I am doing so in order to earn 10 as interest. They see no reason to distinguish between IOUs created by murabahah and IOUs created by lending money. This seems to be underlying the Islamic Fiqh Academy resolution on the subject that states: ‘It is not permissible to sell a deferred debt by the non-

debtor for a prompt cash, from its type or otherwise, because this results in Riba (usury). Likewise it is not permissible to sell it for a deferred cash, from its type or otherwise, because it is similar to a sale of debt for debt which is prohibited in Islam. There is no difference whether the debt is the result of a loan or whether it is deferred sale\(^{44}\). However, the view equating, in this context, money loans and debts resulting from credit has been challenged. There are reasons to treat the two differently, say Chapra and Khan: ‘The debt is created by the murabahah mode of financing permitted by the Shariah and the price, according to the fuqaha themselves, includes the profit on the transaction and not interest. Therefore, when the bank sells such a debt instrument at a discount, what it is relinquishing, or what the buyer is getting, is not interest but rather a share in profit\(^{45}\). In other words, a debt resulting from murabaha has an element absent from a debt arising from borrowing money— the mark up on spot price. Sale and purchase of murabaha-based debt would take place on this extra profit margin.

The problem with this proposition is that what was a profit margin for the seller of goods and services (on a murabahah basis) may not necessarily remain so when the same seller ‘sells’ the IOU arising from that transaction. Some of the factors involved in the determination of the mark up on spot price in murabahah may be different from those involved in the sale of the resulting IOU at a discount. Furthermore, the extra profits earned in murabahah sale, over and above those earnable on selling for cash, are still against sale of goods and services. But the part of it that goes to the buyer of the murabahah based IOU (according to the

\(^{44}\) Islamic Fiqh Academy, 2000, Resolutions and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000, Jeddah, Islamic Research and Training Institute, Islamic Development Bank, p.234

\(^{45}\) Chapra, M.U and Tariquullah Khan (2000), Regulation and Supervision of Islamic Banks, Jeddah, Islamic Research and Training Institute, Islamic Development Bank, p.78
above mentioned rationalization) has no goods and services corresponding to it. It is money for money, with a difference of dates.\textsuperscript{46}

7.7 **Imposing penalty on default payment:**

In credit facilities extended by conventional banks, the loan is invariably tied up with interest that continues to grow with the passage of time. If the client fails to settle the loan upon maturity, this results into the interest burden becoming even larger, and if the delay is unacceptable, sometimes high penal rates of interest are applied. In addition to increasing the income of the lender, this process also acts as a deterrent to defaulting.

In the Islamic system where the Murabahah price is fixed at the outset, no increase may take place in the liability of the client due to delay in settlement. The financier is entitled to claim only the original Murabahah price, irrespective of when it is paid. This could result in some clients purposely delaying settlement in order to avail of free credit period.

This situation could be easily overcome in a place where all financial institutions provide only Islamic facilities, as clients who habitually default could be blacklisted and deprived of further facilities. However, this could be done only with the cooperation of all banks.

When this is not the case, can the financial institution require compensation from defaulting clients after providing sufficient warning, when it is assured that defaulting was deliberate and was not due to poverty? The majority of the contemporary scholars answer in the negative, based on the clear Shari’ah principle that any additional amount charged from the debtor is Riba. Such compensation has no parallel in Islamic Shari’ah. Opportunity cost is not

\textsuperscript{46} For more detail, see his paper entitled ‘ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES’, Presented at the Sixth Harvard University Forum on Islamic Finance, May 5—9, 2004; available at http://www.siddiqi.com/mns/Islamic_Finance_May2004.htm
recognised by Islam. The delay in settlement cannot be construed to have caused a genuine loss to the creditor as money need not necessarily result in a return.

Therefore, in order to discourage defaulting an alternative method could be employed. The client could be made to undertake at the outset of the Murabahah transaction that if he defaults in payment, he would pay a specified amount to a charitable fund maintained by the bank. Such an undertaking to impose a charity on oneself is similar to a vow and therefore is permissible. This would ensure the presence of the necessary deterrent while avoiding charging of interest.

It should be ensured that the client is made to pay this amount only if his defaulting was not due to unavoidable factors, and that the amount thus collected in the fund is only used for charitable purposes approved by the Shari’ah. No portion of it should be added to the income of the bank, nor should it be used for setting off liabilities of the bank.

7.8 The client undertaking to purchase:

The Islamic Shari’ah does not recognise the validity of forward sales where an item currently not in the possession of the seller is sold through sale transaction that becomes effective on a future date. Consequently, the financier in Murabahah may not enter into a forward transaction of sale when the client seeks a Murabahah facility. In this situation, the financier is compelled to purchase the required article from a third party, take possession of it, and thereafter sell it to the client on Murabahah. However, if the client refuses to purchase the article from the bank after the bank had purchased it from the supplier, this could possibly result in the bank being left with an undisposible item.

To avoid this situation that would inhibit financiers from embarking on Murabahah transactions, especially when these involve consumer specific items, the client could be made to enter into a unilateral promise that he would purchase the asset when it is acquired by the financier. A bilateral contract where both the
financier and the client bind themselves to enter into a contract of sale on a future date would be construed as a forward sale, and should be avoided.

It is true that the unilateral promise made by the client in the form of an undertaking to purchase is still a promise, which is not legally enforceable according to most jurists. However, in order to ensure fidelity in commercial transactions, promises made in commercial contexts have been held binding subject to certain conditions, especially when the promisee has incurred some liability on the basis of the promise. If the promisor fails to stand by his promise, he may be legally compelled to fulfil the promise or to compensate the actual loss incurred by the promisee.

Therefore, on the basis of the undertaking to purchase, the client may be legally enforced to purchase the asset from the bank as promised, or, when this is no longer feasible, to pay actual damages to the bank.

Followings are based on the writing of M. Taqi Usmani.

7.9 The use of Interest-Rate as Benchmark

Many banks settle on their profit or mark-up on the basis of the current interest rate, mostly using LIBOR (Inter-bank offered rate in London) as the criterion.

The critics have recourse to disapprove Murabahah on this ground. Contemporary shari‘ah scholars though not advise or encourage to use such benchmark but in the absence of viable Islamic bench-mark they not see wrong in using LIBOR as it is merely mean to have a compleitive market price and does not involve interest transaction at all.

7.10 Promise to Purchase (Binding or Non-binding)

Another important issue in Murabahah financing which has been subject of debate between the contemporary Shari‘ah Scholars is whether promise to
purchase is considered to be binding or otherwise. There has been differing opinion among classical jurists on this issue and hence, contemporary Shari'ah scholars also differ. Taqi Usmani has discussed in detail the opinion of classical jurists and analyzed the issue. According to him:

"Many of classical jurists are of the opinion that 'fulfilling a promise' is a noble quality and it is advisable for the promisor to observe it, and its violation is reproachable, but it is neither mandatory (wajib), nor enforceable through courts. This view is attributed to Imam Abu Hanifah, Imam al-Shafi'i, Imam Ahmad and to some Maliki jurists 1 However as will be shown later, many Hanafi and Maliki and some Shafi'i jurists do not subscribe to this view.

A number of them are of the view that fulfilling a promise is mandatory and a promisor is under moral as well as legal obligation to fulfill his promise and thus promise can be enforced through courts of law. This view is ascribed to Samurah b. Jundub the well known companion of the Holy Prophet Umar b. Abdul Aziz, Hasan al-Basri, Sa'id b. al-Ashwa', Ishaq b. Rahwaih and Imam al-Bukhari. The same is the view of some Maliki jurists, and it is preferred by Ibn-al-'Arabi and Ibn-al-Shat, and endorsed by al-Ghazzali, the famous Shafi'i jurist, who says the promise is binding, if it is made in absolute terms. The same is the view of Ibn Shubrumah. The third view is presented by some Maliki jurists. They say that in normal conditions, promise is not binding, but if the promisor has caused the promise to incur some expenses or undertake some labor or liability on the basis of promise, it is mandatory on him to fulfill his promise for which he may be compelled by the courts."\(^{47}\)

He further contends that: "This is not a question pertaining to Murabahah alone. If promises are not enforceable in the commercial transactions, it may seriously jeopardize commercial activities. If somebody orders a trader to bring for him a certain commodity and promises to purchase it from him, on the basis of

\(^{47}\) Usmani, op.cit., p.122
which the trader imports it from abroad by incurring huge expenses, how can it be allowed for the former to refuse to purchase it? There is nothing in the Holy Qur’an or Sunnah which prohibits the making of such promises enforceable.***

However, the opinion in favour of its bindingness has been resolved by the Council of Islamic Fiqh Academy Jeddah with stipulated conditions.

Securities against Murabahah Price

Another issue is that whether the bank is liable to ask the client to furnish a security in the form of a mortgage or a hypothecation or some kind of lien or charge etc. to its satisfaction or not. Because the Murabahah price is payable at a later date, hence the seller naturally wants to make sure that the price will be paid at the due date. Shari’ah scholars allow it but strongly recommend to fulfill necessary rules.

According to Taqi Usmani, basic rules about this security that must, be kept in mind may be stated as:

“The security can be claimed rightfully where the transaction has created a liability or a debt. No security can be asked from a person who has not incurred a liability or debt. However, the financier can for a security after he has actually sold the commodity to the client and the price has become due on him, because at this stage the client incurs a debt. However, it is also permissible that the client furnishes a security at earlier stages, but after the Murabahah price is determined.

It is also permissible that the sold commodity itself is given to the seller as a security. Some scholars are of the opinion that this can only be done after the purchaser has taken its delivery and not before.”

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*** Usmani, M. Taqi, op. cit, p.125

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7.12 Guaranteeing the Murabahah

The seller in a Murabahah financing can also ask the purchaser/client to furnish a guarantee from a third party. In case of default in the payment of price at the due date, the seller may have recourse to the guarantor, who will be liable to pay the amount guaranteed by him. The rules of Shari’ah regarding guarantee has been dealt in detail in the discourse of Islamic fiqh.

However, some contemporary scholars are considering the problem from a different angle. They feel that guarantee has become a necessity, especially in

49 Usmani, op.cit, p.127
international trade where the sellers and the buyers do not know each other, and the payment of the price by the purchaser cannot be immediate with the supply of the goods. There has to be an intermediary who can guarantee the payment. It is very difficult to find the guarantors who can provide this service free of charge in required numbers.\textsuperscript{50} Keeping these realities in view, some Shari'ah scholars of our time are adopting some different approaches to have the solution which is subject of debate and needs further research as how to resolve this problem rather making a definite ruling to make it a compulsory condition to execute the transaction.

\textsuperscript{50} Usmani, op.cit pp. 129-131
CHAPTER - VIII

CONCLUSION
& SUGGESTIONS
CONCLUSION AND SUGGESTIONS

The appearance of Islamic banking and finance on the scene of global financial world and its rapid growth is an important development of the modern time. It has experienced tremendous growth not only in the Muslim world but also around the western world showing its viability and competitiveness as an arrangement of financial intermediation. The driving force behind the Islamic banking and finance movement was the prohibition of *riba* and permissibility of *bay* (trade) and the spirit of following the *shari‘ah* (Islamic law) principles in undertaking commercial activities. Its theory was primarily developed on the basis of the PLS (Profit & Loss Sharing) principles i.e. participatory (Islamically acceptable) financial contracts, namely, *Musharakah* and *Mudarabah*. However, the practices of Islamic financial institutions failed to conform to the theory and greatly relied on the mark-up principle i.e. *Murabahah*. The PLS (equity based financial arrangement) is in stark contrast to the interest based financing mechanism, but the mark-up principle has not such degree of dissimilarity from the conventional method of lending and financing rather it seems to be similar to conventional financing mechanism.

So far as the operations of Islamic financial institutions are concerned, it is in plain sight that they concentrate on installment sale which is based on the mark-up mechanism. The Islamic banks has so far not heavily based their operations on participatory financing mechanism because of various reasons and practical problems and in place of equity based financing methods, they preferred fixed return or mark-up financing techniques due to its nature of being less risky and meeting the preference of risk averse depositors to give them profit without being bothered with the lurking fear of losses to suffer. Thus Islamic financial institutions seem to be satisfied with this state, but Islamic finance theorists who advocated the model of PLS based financing method as true mode to be
implemented to fully exploit the benefits of such principles, express dissenting views in connection with the extensive use of mark-up mechanism and worried about this state of affair and they (theorists and Shari’ah scholars) have shown concern in understanding the causes of such happening. While deliberating on the problems of Islamic banks, the theorists concentrate on the problems faced in the application of PLS modes, and try to propose the possible solution in its successful implementation but, on the other hand, the practitioners and bankers show their interest in discovering the ways to solve the problems related to mark-up based operations and they try to ignore the issues associated with the difficulties confronted in applying participatory financing mechanism. They do not find such operation viable and practically much workable due to noticeable moral hazard problems & agency problem and in view of the existing environment where the Islamic banks are to compete with conventional banks. Furthermore, the application of PLS modes intensively need a number of tedious jobs like extensive survey of the markets, assessment of credentials and credibility of partners, project evaluation and check & balance activities to monitor the business involved. A minor laxity on their part at times may lead them to be fallen prey to terrible predicament. In the case of liquidity problem, they may find themselves in trouble to come out from unpleasant situation. Moreover, they feel contended to simply play the role of financial intermediary like conventional banks and avoid being involved in trade like activities. On the contrary, Mark-up mechanism is free from such predicaments, rather in such mechanism there are far more options to mitigate the risk. But the main problem is that such method can not be used as a good profitable venture in long term projects and various business activities. Its uses are, to a large extent, limited to short term operations. Thus, there seems a dichotomy between the profitability and feasibility approach. Moreover, the need of the market demand many alteration in the structure of financing operations of Islamic banks that may affect and bypass the objectives of shari’ah (Islamic law) and compromise on the degree of compliance with Islamic law. The trade-off
between the need to preserve distinctive identity of shari'ah compliant financing methods and the needs of the market place makes the practitioners to face a dilemma.

To be brief, the theorists and practitioners are not in harmony in connection with the solution of the problems. The former usually advises the use of profit/loss sharing (PLS) modes and do not support the idea of extensive use of Mark-up (Murabahah) or other trading modes. Whereas, the latter, on the contrary, concentrates to use fixed return trading modes because of its viability in present environment. An attempt is made in the present research to study the mechanism of Mark-up (Murabahah) and its critical examination from the perspective of theory and practice as it is of no dispute that this method is not only being widely used by Islamic financial institutions but also it dominates over the operations of Islamic banks catching a very large share in financing activities in comparison with other modes of finance irrespective of equity based such as Musharakah, Mudarabah or fixed return/sale based forms of financing such as Ijarah, Salam, Ististna etc. The experts esp. theorists has shown high concern on the prevailing dichotomy in the theory and practice of Islamic banking and are not satisfied about its implications for the future of Islamic financial service industry.

Murabahah is a trading instrument in its original layout that has been adapted for financing purposes for providing a facility similar to credit facilities offered by interest based banks, while avoiding involvement in prohibited interest. When carried out correctly with due observance of all requirements, Murabahah provides a lawful means of fulfilling one’s immediate financing requirements at a premium, without being constrained to borrow on interest. However, due to the forced nature of the task Murabahah is required to perform which is not what it is originally designed for, financing on the basis of Murabahah involves numerous conditions, laxity in the observance of which may make the transaction invalid.
This would result in the failure of the basic purpose for which Murabahah was adopted in the first place, which is avoiding violation of Shari’ah.

Thus, the major positive aspect of Murabahah when carried out correctly is that it provides a lawful alternative to financing on the basis of interest, which is no meagre benefit. As far as those who avail Murabahah facilities are concerned, their benefit is principally in the form of avoiding entanglement in the curse of riba, thus ensuring their spiritual and material well being in this world as well as in the hereafter. Involvement in riba or interest, which is a heinous crime tantamount to waging war with Allah Ta’ala and his messenger (may peace be upon him), and which brings on the curse of Allah Ta’ala and his messenger (may peace be upon him) in addition to being the source of a host of economic evils, is replaced with a structure that is not unlawful in Shari’ah. This in itself is a major achievement of Murabahah based financing. Moreover, funds that were paid as interest to conventional banks previously and which served the purpose of furthering the interest based system are now channelled to Islamic banks and their depositors in the form of lawful profit, which is a tangible gain.

However, it should not be forgotten that enjoying the fruits of the economic system propounded by Islam requires more than only evading direct violations of Shari’ah. In fact, Islam has provided complete guidelines for establishing a just economic system that could eradicate social and economic oppression resulting from interest, monopoly, hoarding and speculation, ensuring an equitable distribution of wealth. A vital requirement in this system is the full-fledged adoption of the equity based financing mode of Musharakah and Mudarabah. Utilising a debt based trading tool such as Murabahah in financing could never bring about the real benefits of the Islamic economic system.

Therefore, employing modes such as Murabahah and Ijarah where the net result is not materially different from interest based transactions, should be restricted to instances where adopting Musharakah and Mudarabah etc. is not
feasible. Widespread use of Murabahah in all spheres of financing should be curtailed and means for widening the scope of application of Musharakah actively sought, facilitating the gradual transition from Murabahah based structures to full-fledged implementation of equity based financing such as Musharakah & Mudarabah which executed on the principle of Profit and Loss Sharing (PLS).

As stated in the introductory chapter, the primary objective of the study is to analyze the present practices of Islamic banking with special reference to the most used form of financing method i.e. Mark-up (Murabahah). To achieve this objective, first, a methodological approach to understanding the concept of Islamic banking and finance was developed. Second, the study examined how the structure and practices of Islamic banking differ from those of conventional banking. In this connection the distinguishing features and advantages of Islamic financial system was highlighted. Since the Murabahah method is basically a sale contract, the perquisites of sale was analyzed in relation to Murabahah as how these rules could be fulfilled and fully applied if this sale contract is used for financing purposes.

Second, to evaluate the theoretical and practical development of the concept of mark-up (Mrabahah) in contemporary Islamic banking and finance. To achieve this objective the study investigated the past practices of classical Murabahah contract and its evaluation though the survey of classical fiqh literature as which forms of this specific contract was approved by classical jurist and how the concept of contemporary Murabahah financing was developed and adapted by modern jurists in order to use it as a financing mechanism in the operation of Islamic banks and financial institution.

Third, to see the change in the trend of Murabahah operation used by Islamic banks so as to find out as whether there happened any change in its use as a dominant operation or the use of other financing technique got increased in comparison with Murabahah operation. To this end, an empirical analysis was attempted to make the trend of different financing methods as compared to
Murabahah technique used by commercial Islamic banks of GCC countries during the period 2000-2005. The rest of study presented a comprehensive review on different issues related to the subject.

The study critically analyses the main functioning and features of the conventional and Islamic banking system and demonstrates as how Islamic banking system is a viable proposition that can result in efficient resource allocation and prove to be an alternative to contemporary interest based financial system. They can be summed up as follows:

1. It is argued that banks in an Islamic system face fewer solvency and liquidity risks than their conventional counterparts. The multi-purpose and extra-commercial nature of the Islamic banking operation does not seem to pose intractable problems. The abolition of interest makes it imperative for Islamic banks to look for other instruments, which renders operations outside the periphery of commercial banking unavoidable. Such operations may yield economies of scope.

2. Unlike conventional banking, Islamic bank is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis and thus can play a catalytic role in stimulating economic development.

3. Conventional finance typically focuses on profit-maximization within a given regulatory framework, whereas Islamic finance is also guided by other Islamic principles that have certain social objectives for the benefit of human beings and society. It strictly prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another.
4. Unlike conventional banking, commercial banking in an Islamic framework is not based on the debtor-creditor relationship. Islamic banks have more stringent Know-Your-Customer requirements than conventional banks which rely on documentary evidence and usually have impersonal, arms-length, passive relationships with the majority of their clients and therefore less concerned about the character and credibility of their clients or the moral implications of the business venture for which money is lent.

5. Under Islamic financial system, the underlying principle which is applicable to both labor and capital is that there should not be any reward without taking a risk. i.e. no payment is allowed for labor, unless it is applied to work, or there is no reward for capital unless it is exposed to business risk.

6. The Islamic financial system is based on equity whereas the conventional banking system is loan based and interest is considered to be the price of credit, reflecting the opportunity cost of money. They are often, more pre-occupied with the underlying securities and assets. whereas, Islamic banks are engaged in a quasi-partnership profit-loss sharing framework and therefore have to know their clients, their businesses, as well as, their sources and uses of funding in order to satisfy themselves about the authenticity and legitimacy of their counterparties. Thus, they would be in a much better position to detect, prevent and disengage quickly from suspicious transactions compared to conventional banks.

The study has also dilated upon the essentials of Islamic finance concept, that must be fulfilled, otherwise the operation could no more be sharia'h compliant or shari’ah based. These can be summarized as:

a) Any predetermined payment over and above the actual amount of principal is prohibited.
b) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.

c) Making money from money is not Islamically acceptable.

d) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.

e) Gharar (Uncertainty, Risk or Speculation) is also prohibited.

f) Investments should only support practices or products that are not forbidden (i.e. Transactions in unethical goods and services; Earning returns from a loan contract (Riba/Interest); Compensation-based restructuring of debts; Excessive uncertainty in contracts (Gharar); Gambling and chance-based games (Qimar); Trading in debt contracts at discount, and; Forward foreign exchange transactions etc.).

Our analysis also highlighted the resultant benefit and advantages that could be emerged from adopting such interest free financial system from the perspective of efficiency, stability, moral hazard and adverse selection, role in economic development, integrity, equity and sustainability etc.

Since the Mark-up (Murabahah) is originally a sale contract which was later adapted for financing purpose and got developed as the most used method of finance in contemporary Islamic banking operation, we have dealt with the concept of sale contract discussing its type, ethics and basic rules that are necessary for the execution of a sale. There are mainly two types of sale with respect to structure i.e. the common or generally widespread sale and specific which constitute the form of 'Trust (amanah) sales. Murabahah falls under the latter category. These different types of sale are known as Musawamah, Tawliyah, Wadiah and Murabahah. The last three ones are categorized as trust sales. The musawamah (Negotiation or bargaining sale) can be defined as a sale at the agreed upon price without reference to the original price of the commodity. This forms
the most common type of sale. *Tawliyah* (At-cost sale or investiture) is a sale in which the object is resold to the buyer for the same price at which the seller obtained it, whereas *wadiah* (sale at a loss), on the contrary, is a kind of sale in which seller sells the commodity (with a known discount) at a price below the original price. *Murabahah*, just quite reverse, is a sale of the commodity at original price plus a stated agreed upon profit margin. It is called as cost-plus sale or Mark-up. As for the basic rules of sale, the main purpose of discussing them is from the viewpoint that if Murabahah is adapted for financing purposes, these rules too would be applied to such Mark-up mechanism and could not be ignored. However, there may be further stipulated some specific conditions to its proper execution so that its compliance with shari‘ah principle may not be compromised while accepting it as a financing method. The principal conditions that primarily concern in connection with mark-up financing mechanism are taking the real ownership/ possession avoiding any sort of ambiguity in fixing the price of the commodity that must exist. In addition to this, an important issue which may occur in such sale contract, was also discussed under the head ‘options of sale’ which in connotation of Islamic law (*jurisprudence*) are termed as ‘*Khiyar*’. They refer to a specific type of right of either or both parties to the contract to confirm or rescind the contract so as to avoid the potential disputes that may arise due to some sort of uncertainty (*jahalah*) or absence of relevant information (*gharar*).

The study also highlights the unprecedented growth of Islamic banking and finance in the contemporary finance world. Our analysis captures the advancements of Islamic banking and finance industry across the globe from South-East Asia to Middle-East and Europe. Our study has found that the Middle East countries contribute the highest share in respect to geographical distribution i.e. 53% followed by Indian sub-continent, South-East Asia, Africa and the rest of the world as 16%, 13%, 9% and 9% respectively. We have mainly presented a general review that bears facts and figures over the recent developments of Islamic
banking and finance across the globe. It takes stock of the growing institutional and infrastructure support for the Islamic banking and finance system in Muslim countries and Western financial markets.

The findings of our analysis hold that Islamic banking and finance industry has been making breakthrough improvements to become a truly viable and competitive alternative to conventional systems at the global level. Islamic banking and finance institutions have acquired booming grounds in the Middle East, South-East and South-East Asia. After leading conventional bank such as Citibank, HSBC, BNP Paribas, Barclays and USB started offering Islamic financing products on a basic level through dedicated Islamic banking windows or divisions, other leading conventional banks too began to follow the suit which further fueled its mounting growth. These growing Islamic hubs have been acting as a launching pad to promote Islamic banking in Western business and financial markets. Experts attribute to various core factors contributing to the recent success of Islamic banking and finance, such as high liquidity in GCC because of oil production, prolonged boom in the Middle-Eastern economies, product innovation and sophistication, increasingly receptive attitude of conventional regulators and information technology advancements that have been acting as a catalyst for the Islamic banking and finance industry to go global. Given all growth patterns, Islamic banking may be able to win over the majority of customers from the Muslim world that constitutes almost 24 per cent of the world's population (over 1.3 billion), and other ethical groups across the globe in times ahead. Our study has mostly born a subjective outlook taking the stock of on-going developments in Islamic banking and finance industry worldwide and dealt with some latest information, facts and figures, which however do not amount to a substantive volume and not meant to make analysis to figure out the main factors and their actual contributions in making Islamic banking and finance emerge as the fastest growing industry of the global finance. This overview suggests that Islamic
banking industry has been increasingly growing at the rate of 15%-20% over the past many years.

In Murabahah contract, theorists always implicitly stress the sale aspect whereas a transaction has normally two aspects purchase and sale. However, our findings hold that the original type of Murabahah arose as a result of a buyer wanting to buy certain goods either for own use or to participate in his trade, but about the nature as details of which (i.e. price, quality, markets etc.) he/she does not have expertise. Hence he/she engaged the services of another person who is conversant with these aspects. The remuneration he offered the consultant is not for per diem (as an employee) but as a mark-up on the goods stressing his/her independent status. In this case the aspect of credit did not enter into the relationship between the two parties at all and the mark-up would be clearly only for the expertise if the finance for the purchase was provided by the ultimate buyer. We, thus find that what sort of situation actually prevailed in the past is different from contemporary state of affairs widespread in modern Islamic banking system. The present practice in respect of credit involved financing as such in Murabahah is completely at variance with that obtained in classical Murabahah.

The discourse on Murabahah is found in almost all main schools of Islamic jurisprudence, however, it was not much discussed or touched upon by the earliest jurists but the later jurists of these schools tried to discuss in rather detail the different form of Murabahah sale and its aspect in the light of shari’ah principles. All are unanimous that Murabahah is special kind of sale with the original price (capital cost) and an added on profit and for validity of this contract, it is compulsory on the seller to fully disclose the original cost to the buyer and the surcharge, extra amount of profit must be known and mutually agreed upon. However, the classical jurists have some degree of difference with respect to different forms of Murabahah. Particularly in relation to specific variety of Murabahah sale, some has disapproved or regarded as *makruh* while others
thought otherwise. The opposing opinion mainly occurred on the form of Murabahah on purchase order and what way of determining the profit should be allowed. The later jurists of Hanbali School have provided many grounds to argue for the approval of different aspect of Murabahah.

As far as the legitimacy of Murabahah is concerned, our analysis finds that the legal evidences or indicators variously adduced by the classical jurists for the legitimacy of Murabahah contract are mainly general in nature and not at all specific to Murabahah. Hence, later classical jurists had recourse to legal principle when explaining the legitimacy of Murabahah: ‘It is lawful owing to its meeting all the conditions for validity’. They conclude that the basic principle is the permissibility of things, and no clear text exists prohibiting such a transaction. As regards the rationale of Murabahah, they hold that there is a great need for this sort of dealing because one inexperienced in the ways of business will have to depend on those more experienced, and be satisfied with paying as much as the more experienced one has paid.

As for our empirical analysis made to know the concentration and growth of Murabahah in financing activities of GCC commercial banks, we find that Murabahah is the most dominating financing technique used by Islamic banks in GCC countries. At times it seems that some banks use Murabahah as their sole financing technique. Its average percentage share stayed at (56.13%) over the period 2000-05. The second most popular form of financing used by GCC Islamic banks is Muajjal followed by Ijarah which averaged out at (27.27%) and (6.41%) over the period 2000-05 respectively.

We also observe from Murabahah financing growth rate that there is U-shape change. During 2000-01, the percentage increase was (14.28%) and then (8.04%), (-2.40%), (9.07%) during 2001-02, 2002-03 & 2003-04 respectively. During 2004-06, the growth rate unexpectedly reached as high as (16.13%) which was the ever high increase over the period. One may conclude from this U-shape
change in Murabahah operation that the use of this form of financing has gradual decline as its share has been reduced over the past years (i.e. 2000-04) which means that the Islamic banks is swiftly increasing the shares of other financing operations, but abruptly or phenomenal high percentage increase of (16.13\%) during 2004-05 demonstrate otherwise and thus indicating that the banks still have heavy reliance on Murabahah operation (a fixed return mode of finance).

However, as we assumed that Islamic banks would rise to the challenge of normative Islamic economists and scholars to increase profit sharing and decrease Murabahah based financing. This somewhat plays down the economic rationale behind the prevalence of Murabahah, which we predict will remain the predominant mode of financing for Islamic banks, as a result of moral hazard concerns. For us to assume that profit sharing will increase just as a result of pressure or whatever reasons is somewhat superficial. Also, a number of Islamic banks particularly in the gulf have a number of restricted investment accounts which invest on a profit sharing basis on equity based projects whether companies or development projects or other. However, the AAOIFI standards require these to be reported off-balance sheet in a separate statement and as a result we will not see these on the balance sheet analysis that we are conducting.

There is also another theory that suggests that Islamic banks will move to profit sharing modes when the moral hazard concerns in their economies alleviate and financial instruments and investments diversify. This will happen when the financial system and wealth of individuals develops more and therefore people have more wealth to diversify. When they don’t have wealth to diversify, investors will prefer low risk deposit returns and therefore Islamic banks will engage in low risk Murabahah investments rather than equity based projects.

The major findings of the study can be summarized as follows:

1. Murabahah is still a dominant and widely used financing technique in comparison with other Islamic methods of finance.
2. The present practice in respect of credit involved financing as such in Murabahah is completely at variance with that obtained in classical Murabahah.

3. Murabahah has played the major role in the growth of Islamic banking and finance industry.

4. The attitude of Islamic banks while practicing Murabahah is largely focused on to mitigate the risk as much as possible and make it a close competitive alternative to conventional loans as it is evident from the introduction of commodity Murabahah/ dealing in synthetic Murabahah in which the essentials of Murabahah esp. the actual ownership of goods is rather symbolic than real.

5. Murabahah is the most dominating financing technique used by Islamic banks in GCC countries, staying its average percentage share at (56.13%) over the period 2000-05 followed by Muajjal and Ijarah which averaged out at (27.27%) and (6.41%) over the period 2000-05 respectively.

We suggest that:

a) Future prospects of Murabahah depend on the extent to which Murabahah receivables repackaged as sukuk are considered tradable.

b) The issue of penalty for default in case of Murabahah has still to be resolved in a manner which compensates the banks for any loss suffered because of the delay in payment.

Thus, to our mind, the recent upsurge in Murabahah seems particularly due to practical resolution of the two issues noted above.

Nevertheless, this still leaves out the main objectives against Murabahah i.e. it is geared towards short-term financing. The present trend is to take recourse to equity.
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GLOSSARY

Followings are the glossary of islamic banking terminology:

**Amanah:** Trust, with associated meanings of trustworthiness, faithfulness and honesty. As an important secondary meaning, the term also identifies a transaction where one party keeps another's funds or property in trust. This is in fact the most widely understood and used application of the term.

**Ar bun:** Earnest money/Down payment; a pre-purchase deposit paid by the client (buyer) to the seller upon concluding a contract of sale, with the provision that the contract will be completed during the prescribed period.

**Bai' Muajjal:** Literally it means a credit sale. Technically, a financing technique adopted by Islamic banks that takes the form of Murabaha Muajjal. It is a contract in which the seller allows the buyer to pay the price of a commodity at a future date in a lump sum or in instalments. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

**Bai al-Dayn:** (Debt financing) the provision of financial resources required for production, commerce and services by way of sale/purchase of trade documents and papers. Bai al-Dayn is a short-term facility with a maturity of not more than a year. Only documents evidencing debts arising from bona fide commercial transactions can be traded.

**Fiqh:** Islamic jurisprudence (or Islamic law), practical rules of Shari’a derived from the detailed evidence in the textual sources. It is an important source of Islamic economics. **Fuqaha:** jurists or those well versed in fiqh.

**Fatwah:** A religious decree.

**Gharar:** It means any element of uncertainty in any business or contract about the subject of contract or its price, or mere speculative risk. It leads to undue loss to a party and unjustified enrichment of other, which is prohibited.
**Al Ghunm bil Ghurm:** This provides the rationale and the principle of profit sharing in Shirkah arrangements. Earning profit is legitimized only by engaging in an economic venture, risk sharing and thereby contributing to the economy.

**Hanafi:** name of a Sunni school of law, associated with the early religious leader (Imam) Abu Hanifa (d. 767)

**Hanbali:** name of a Sunni school of law, associated with the early religious leader (Imam) Ahmad ibn Hanbal (d. 855)

**Halal:** That which is permissible, reverse to *haram* (unlawful). In Islam there are activities, professions, contracts and transactions which are explicitly prohibited (haram) by the Qur'an or the Sunnah. Barring them, all other activities, professions, contracts, and transactions etc. are halal. This is one of the distinctive features of Islamic economics vis-a-vis Western economics where no such concept exists.

**Ijarah:** Letting on lease. Sale of a definite usufruct of any asset in exchange of definite reward. It refers to a contract of land leased at a fixed rent payable in cash and also to a mode of financing adopted by Islamic banks. It is an arrangement under which the Islamic banks lease equipments, buildings or other facilities to a client, against an agreed rental.

**Ijarah-wal-Iqtina':** A mode of financing adopted by Islamic banks. It is a contract under which the Islamic bank finances equipment, building or other facilities for the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rental as well as the purchase price are fixed in such a manner that the bank gets back its principal sum alongwith with some profit, which is usually determined in advance.

**Ijtihad:** It refers to an endeavor of a qualified jurist to derive or formulate a rule of law to determine the true ruling of the divine law in a matter on which the
revelation is not explicit or certain, on the basis of Nass or evidence found in the Holy Qur'an and the Sunnah.

*‘Ilah*: determination of effective cause or rationale in Islamic legal reasoning.

*Ijma‘*: Consensus of all or majority of the leading qualified jurists on a certain Shariah matter in a certain age.

*‘Inah* (A kind of *Bai*): Double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, with the net result a loan with interest.

*Istihsan*: juristic preference to achieve equity and avoid a harsh result, a legal method particularly associated with the Hanafi school of law that particularly allows exception to strict legal reasoning, or guiding choice among possible legal outcomes, when considerations of human welfare so demand.

*Istisna‘a*: It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. Istisna‘a can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, building of bridges, roads and highways.

*Jahl* or *Jahala*: Ignorance, lack of knowledge; indefiniteness in a contract, sometime leading to Gharar.

*Ju‘alal*: (Lit: stipulated price for performing any service.) Technically applied in the model of Islamic banking by some. Bank charges and commission have been interpreted to be ju’ala by the jurists and thus considered lawful.

*Kali bil-Kali*: The term Kali refers to something delayed; appears in a maxim forbidding the sale of al-Kali bil-Kali i.e. the exchange of a delayed counter value for another delayed counter value.

*Al- Kafalah (Suretyship)*: Literally, Kafalah means responsibility, amenability or suretyship, Legally in Kafalah a third party become surety for the payment of debt. It is a pledge given to a creditor that the debtor will pay the debt, fine etc.
**Kharaj bi-al-Daman:** Gain accompanies liability for loss; a Hadith forming a legal maxim and a basic principle – see also Al-Ghunm bil Ghurm.

**Khiyar:** Option or a power annul to or cancel a contract.

**Khiyar al-Majlis:** Option of the contracting session; the power to annul a contract possessed by both contracting parties as long as they do not separate.

**Khiyar al-Shart:** A right, stipulated by one or both of the parties to a contract, to cancel the contract for any reason for a fixed period of time.

**Maisir:** An ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels. It came to be identified with all types of hazard and gambling.

**Makruh:** an act considered repugnant under Islamic law.

**Maliki:** name of a Sunni school of law, associated with the early religious leader Malik ibn Anas (d. 796)

**Maqasid-e shariah:** hierarchy of legal aims or objectives of Islamic law.

**Mu’amalat:** sphere of Islamic law governing human or social relationships such as most property rights, as distinct from *ibadat*, matters relating to worship.

**Mubah:** an act considered permissible under Islamic law.

**Mudarabah:** A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider of the capital.

**Murabaha:** Literally it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and profit. This has been adopted by Islamic banks as a mode of financing. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is settled in advance.
**Musawamah:** Musawamah is a general kind of sale in which price of the commodity to be traded is bargained between seller and the purchaser without any reference to the price paid or cost incurred by the former.

**Musharakah:** Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

**Qimar:** Qimar means gambling. Technically, it is an arrangement in which possession of a property is contingent upon the happening of an uncertain event. By implication it applies to a situation in which there is a loss for one party and a gain for the other without specifying which party will lose and which will gain.

**Qiyas:** Literally it means measure, example, comparison or analogy. Technically, it means a derivation of the law on the analogy of an existing law if the basis ('illah) of the two is the same. It is one of the sources of Islamic law.

**Riba:** An excess or increase. Technically, it means an increase over principal in a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense ('iwad) in return to the other party; every increase which is without an 'iwad or equal counter-value.

**Al-Rahn:** Pledge, Collateral; legally, Rahn means to pledge or lodge a real or corporeal property of material value, in accordance with the law, as security, for a debt or pecuniary obligation so as to make it possible for the creditor to recover the debt or some portion of the goods or property.

**Al-Sarf:** Basically, in pre-Islamic times it was exchange of gold for gold, silver for silver and gold for silver or vice versa. In Islamic law such exchange is regarded as 'sale of price for price' (*Bai al Thaman bil Thaman*), and each price is
consideration of the other. It also means sale of monetary value for monetary value – currency exchange.

Shafi'i: name of a Sunni school of law, associated with the early religious leader Muhammed al-Shafii(d. 820)

Shariah: The term Shariah refers to divine guidance as given by the Holy Qur'an and the Sunnah of the Prophet Muhammad (PBUH) and embodies all aspects of the Islamic faith, including beliefs and practice.

Shari'ah advisor: A professional, usually a classically trained Islamic legal scholar that advises an Islamic bank on the compliance of its products and services with the Shari'ah, or Islamic law.

Sukuk: Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. Sukuk are securities that comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. It is a certificate of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or investment activity.

Sunnah or (Hadith): Custom, habit or way of life. Technically, it refers to the utterances of the Prophet Muhammad (PBUH) other than the Holy Quran known as Hadith, or his personal acts, or sayings of others, tacitly approved by the Prophet.

Takaful: mutual responsibility, mutual guarantee, Islamic insurance.

Talfiq: the legal method of 'patchwork' combining approaches or principles from different Islamic schools of law.

Tawarruq: Reverse murabahah. As used in personal financing, a customer with a genuine need buys something on credit from the bank on a deferred payment basis and then immediately resells it for cash to a third party. In this way, the customer can obtain cash without taking an interest-based.

ulama/ulema: clerics or Sharia'h scholars.
'urf wa adah: custom and usage, a general or local model of behaviour, social understanding, or mode of expression, that is generally accepted by the population and does not contract a definitive rule of Islamic law (Shari'ah).

usul al-Fiqh: methodology applied to the Qur'an and Sunna to deduce the rules of fiqh, or substantive law.

Zakat: general charitable payment, levied on property such as gold, silver, merchandise and income producing animals, as well as land, required of all Muslims to purify both themselves and their wealth.