

SHARI`AH COMPLIANCE IN THE ISLAMIC BANKING AND FINANCIAL INDUSTRY: MYTH AND REALITY

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The aim of this paper is to evaluate the effect of Islamic schools of thought on the Islamic banking and financial industry. This paper adopts descriptive and analytical research approaches. It concludes that Islamic banks do not really fulfill Islamic economical philosophy as most of the Islamic contracts offered by them do not strictly adhere to the Islamic law. Thus, policy makers and regulators need to restructure the Islamic banking and financial industry in order to make it truly operate according to the Islamic law.

INTRODUCTION

The basic components of Islam are categorised into three groups: faith and belief (*aqidah*), ethics and morality (*akhlaq*), and practices and activities (*Shari'ah*). *Shari'ah* means “the way that directs man’s life to the right path,” and the meaning of law comes from the phrase “the right path”. The law that governs this component is *Shari'ah* law (*hukm Shari'ah*). In another definition, *Shari'ah* is “a shared opinion of the community, based on a literature that is extensive, but not necessarily coherent or authorised by any single body”.¹⁸ *Shari'ah* guides all the practical aspects of a Muslim’s daily life, including worship, daily routines, food, trading, and so forth. A Quranic verse captures this idea: “Truly, my prayer and my service of sacrifice, my life and my death, are (all) for Allah (*s.w.t.*), the Cherisher of the Worlds” (Al-Anam 6:162). The *Shari'ah* guideline is divided into *ibadat*, which deals with the relationship between man and Allah (*s.w.t.*), and *muamalat*, which addresses the relationship between individuals.

Thus, Islamic business and finance based on *Shari'ah* principles. Specifically, Islamic business and finance based on the notion that

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Allah (*s.w.t.*) is the true owner of the world's wealth and He delivers it to human beings. This perspective called the vicegerency of man theory (*isikhlaf*) and posits out that human beings may own property and wealth during their lifetime and that they have the right to utilise that property in any way that permitted by Allah (*s.w.t.*). Therefore, the objectives of Islamic banks differ fundamentally from western style of banks because the former revolve around the prosperity of society. Several scholars have tried to propose a definition for Islamic economics. Zaman was among the first researchers to propose a definition of Islamic economics as: "Islamic economics is the knowledge and application of injunctions and rules of the *Shari'ah* that prevent injustice in the acquisition and disposal of material resources in order to provide satisfaction to human beings and enable them to perform their obligations to Allah (*s.w.t.*) and the society".³²

Chapra, a leading Islamic economist, defines Islamic economics in his book entitled: "What Is Islamic Economics", as: "[T]hat branch of knowledge which helps realise human well-being through an allocation and distribution of scarce resources that is in conformity of with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances".³² From these definitions, it can be said the Islamic economic system strives for a just, fair, and balanced society as envisioned by *Shari'ah* (*maqasid al-Shari'ah*). According to bin Al-Qaiyyim, the basis of the *Shari'ah* is the wisdom and welfare of the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the *Shari'ah*.³¹

Islamic business and finance are part of the Islamic economic system. The structure of Islamic business and finance revolves around the prohibition of *riba* and the encouragement of trade. Furthermore, Islamic banks operate according to the *al-ghurm bi al-ghunm* principle, which means that entitlement of gain is linked to the responsibility of loss. This principle puts the financier

(Islamic bank) and borrower at the same degree of risk. Therefore, Islamic banks have their own view of the function of money in society, as they consider money a means for economic prosperity. The priority of Islamic banks is to grow, not only through a profit-and-loss scheme but also through a true understanding of the role of capital in society, which derives from the Islamic concept of *istikhlaf*. In Islam, Allah (*s.w.t.*) owns man and all the riches on Earth, but Allah (*s.w.t.*) made man vicegerent (*mustaklif*) on the Earth. Thus, human beings are caretakers not only of themselves but also of society and the rest of creation. This system helps maintain a balance in life. Therefore, the goals of Islamic banks can be summarised into:

1. providing *Shari'ah* compliant and prudent banking opportunities to Muslims to help them avoid usurious agreements; and
2. achieving the goals and objectives of an Islamic economic system.

However, Islamic banks depends on *murabahah* contracts as stated by many authors,^{2,23} and this contract, as practiced by Islamic banks, do not adhere to Islamic law (see Table 1).^{8,28,35} Moreover, the legitimacy of *sukuk* which based on the standards set by Bahrain based organization, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), been investigated and been found that they are not adhering to Islamic law (see Table 2).^{44,45} Furthermore, some researchers argued that Islamic financial instruments do not differ from their conventional counterparts.^{8,19,38,39}

Table 1: Comparing the features of traditional and contemporary *murabahah* contract³⁵

Traditional <i>Murabahah</i>	Contemporary <i>Murabahah</i>
The customer orders a product unavailable in his or her locality	The customer knows where the product is available
The product is not in his or her capacity	The product is in his or her capacity but exceeds his or her financial capacity
The customer does not know the original cost	The customer knows the original cost

Contd...

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Only the merchant knows the original supplier	The customer knows the original supplier
The merchant searches for the product in question	The customer himself searches for the product
The merchant locates, negotiates, and orders the product	The customer locates, negotiates, and orders the product
Transactions take days or months to complete – depending on the distance, availability of product, mode of transportation, etc.	Transactions take only a few minutes
The customer does not act as agent	The customer can be appointed as agent on behalf of the Islamic financial institute to purchase the article
The merchant bears all the risks of purchase and transport	The customer bears all the risks of purchase and transport
The customer has the right to cancel the contract upon inspection of the article	The customer is the ultimate buyer of the product and cannot revoke the contract

Table 2: Analysis of sukuk⁴⁴

Originators	Types of Sukuk	Fully AAOIFI Shari'ah standard compliant	Remarks
Kuala Lumpur Sentral Pvt. Ltd.	<i>Musharakah</i>	No	Approved by the Securities Commission Shari'ah Advisory Council (SCSAC)
Nomura Sukuk Ltd	<i>Ijarah</i>	No	Approved by the Shari'ah advisors of Kuwait finance home
Sun Finance Limited	<i>Mudaraba</i>	No	Approved by the Citi Islamic Bank's Shari'ah Advisory Board
PERTAMINA (Indonesia)	<i>Istisnaa</i>	No	Dewan Pengawas Syariah or Shari'ah Overseer Board
United Arab Bank	<i>Murabahah</i>	No	Compliance with UAB Islamic Banking Shari'ah Supervisory Board
United Arab Bank	<i>Salam</i>	No	Compliance with UAB Islamic Banking Shari'ah Supervisory Board

Another issue that made the contemporary Islamic finance industry controversial is *fatwa*. *Fatwa* is required on issues where there is no clear and forthright guidance from Quran and *Sunnah*. However, the *fatwa* issued by Islamic scholars often have different point of view due to the foundation, school of thoughts, used to produce the *fatwa*. This led to *fatwa* shopping and made the Islamic finance industry debatable. For example, transaction such as *bay al-muajjal* and *bay al-inah* are rejected by most of the Islamic scholars in the world except Malaysia. In this manner, Islamic banks are not really fulfilling the Islamic economic philosophy of promoting equity, fairness, and distributive justice in society. Hence, the main objective of this article is to evaluate the effect of Islamic schools of thought on the Islamic financial industry.

ISLAMIC LAW AND ISLAMIC FINANCIAL CONTRACTS

Sources of Islamic Law

In general, *Shari'ah* rulings are derived from the Quran and the *Sunnah*, which are the primary sources. However, these two sources leave room for different interpretations. Therefore, Muslims often have to resort to secondary sources of *Shari'ah* derived from the primary sources and can only be written by qualified experts. These primary and secondary sources discussed briefly in the next two sections.

Primary sources

Primary sources are those that unanimously agreed upon by the four major schools of Islamic thought or Islamic law. Ahmad Hasan explains, "The Quran is the primary source of law. The other three sources, i.e., the *Sunnah*, *ijma*, and *qiyas* have been stamped with the revelatory character".²⁴ These sources described below in descending order of importance.

The Quran is the primary source of Islamic law and been revealed to the Prophet Muhammad (*s.a.w.*) over a period of 23 years. The Quran contains 6,219 verses (*ayats*), collected in 114

Chapters, which called *Surah*, but only about 600 deal specifically with legal matters. The Quran is without a doubt the most basic, uncontroversial, and fundamental source of *Shari'ah*.

Hadith and *Sunnah* are considered as the second supreme source of Islamic law. In the Arabic language, *hadith* literally means a story, a narration, or report; and *Sunnah* means a way or practice. *Hadith* and *sunnah* stand for all of what the Prophet Muhammad (*s.a.w.*) did, said, and tacitly approved, plus all the reports that describe his *sifaat* (features), including his physical appearance, attributes, and character. However, some jurists do not include the physical appearance of the Prophet Muhammad (*s.a.w.*) in their definition of *hadith*. There are several classifications of *hadith*, five of which shown in Figure 1.

Ijma is a consensus on any given matter by all qualified legal Muslim scholars of any period following the death of the Prophet Muhammad (*s.a.w.*). *Ijma* is widely considered one of the most significant sources of Islamic law because they encompass scholarly agreement on the authenticity of a given text, its meaning, and its implications.⁴⁶

Qiyas is a process in which Muslim legal scholars compare and apply existing law to a new situation not currently governed by law.⁴⁶ *Qiyas* guidelines derive their value from the three other sources (the Quran, *hadith* and *Sunnah*, and *ijma*); hence, *qiyas* guidelines are considered infallible because they are drawn logically from other infallible sources. *Qiyas* is a branch of *ijtihad*, which explained in the next section.

Secondary sources

There are other sources of *Shari'ah* besides those mentioned above. However, the four Islamic schools of thought do not unanimously accept these sources. Still, this does not mean that they cannot be used to derive a particular *Shari'ah* ruling. There are many secondary sources and six common types explained below.

Ijtihad is an intellectual effort by a scholar to derive a rule for a problem from the Quran, *Sunnah*, *Ijma* or *Qiyas*. This process can only be done for issues that are not already addressed in Islamic

jurisprudence. Only scholars who have a complete grasp of all legal verses of the Quran (*ayat al-abkm*) can interpret Islamic law through the process of *ijtihad* (these scholars called *mujtahid*). In addition, these scholars must be knowledgeable of *Sunnah* and the strengths and weaknesses of various *ahadith*. Furthermore, they must be well versed in the principles of deriving Islamic legal theory (*usulal-fiqh*) and they must know the society's general juristic maxims (*al-qawadid al-fiqhiyaah*).⁴⁶ The origins of *ijtihad* can be traced to the early days of Islam. This can be drawn from the *ahadith* of the Prophet Muhammad's conversation with Muadh bin Jabal before dispatching him to Yemen as a ruler and teacher to its people.

The Prophet Muhammad (*s.a.w.*) asked Muadh: "How will you adjudicate a matter when it comes to you?" Muadh replied, "I shall decide on the basis of Allah's Book (the Quran)". The Prophet asked, "If you do not find it in Allah's Book (what you will do)?" Muadh replied, "then, on the basis of the *Sunnah* of Allah's Messenger". "If you do not find it even in the *Sunnah* of Allah's Messenger, (what you will do)?" the Prophet Muhammad (*s.a.w.*) asked. Muadh replied, "I shall make *ijtihad* on the basis of my understanding and will not spare any effort (to reach the truth)". On this, the Prophet Muhammad (*s.a.w.*) said, "Praise be to Allah, who has let the messenger of the Messenger of Allah do what pleases Allah's Messenger".⁴⁶

Istihsan (juristic preference) literally means "to approve" or "to deem something preferable".⁴⁶ *Istihsan* is a Hanafi and Maliki principle and was defined by Hanafi jurist Al-Hasan Al-Karkhi (died AD 951) as: "departing from an existing precedent by taking a decision in a certain case different from that which has been decided in similar case, for a reason that is stronger than the one obtained in those cases".⁴⁶

Istishab (presumption of continuity) defined as a ruling that "maintains the status quo".⁴⁶

Maslahah mursalah, or *istislah*, (consideration of the public interest) *maslahah* literally means benefit and *mursalah* means unrestricted. It refers to unrestricted public interest that *Shari'ah*

seeks to protect. This supported by several *hadiths* like: “No injury/harm shall be inflicted or reciprocated”. *Maslahah* can be classified into three categories based on their level of importance: (a) *daruriyyat* (essentials); (b) *hajiyyat* (complementary); and (c) *tahsiniiyyat* (embellishment). However, *maslahah* needs to meet some conditions to be valid. That is, *maslahah* must be genuine, must be general (*kulliyah*), and must not contradict to a clear *nass* (Quran or *Sunnah*). To be noted that some Maliki and Shafi scholars do not consider it a source of law.

Sadd al-dharai (precautionary legal prohibition) defined by Al-Qurtubi as: “a matter which is not forbidden in itself but which is feared that might lead to something which is forbidden, if committed”.⁴⁶

An *Urf* (social tradition) is an argument behind *istihsan* and *istislah*. *Urf* defined in *usul al-fiqh* as: “recurring practices, which are acceptable to people of sound nature”.³⁰ For an *urf* to be adopted it cannot violate an explicit *nass* injunction.

Islamic Schools of Thought (Madhab)

The word *madhab* literally means “to go” or “to take as a way” and refers to schools of thought on *fiqh* (religious jurisprudence). Different schools of thought interpret religious material through three major lenses: beliefs, religious practices, and laws (*Shari`ah*). In practice, the differences between these schools of thought are minor. Furthermore, the followers of the different schools do not distinguish themselves according to it as they simply refer to themselves as *Sunnis*. There are four *madhabs* in Islam and there are listed below in historical order.

The founder of the Hanafi school of thought was Imam Abu Hanifa Al-Numan bin Thabet. He was born in AD 699 in Kufa, was raised there, and died in Baghdad in AD 767. Many historians and scholars believe that Abu Hanifa was second generation in oral transmission from the Prophet Muhammad (*s.a.w.*) because he met Prophet’s companion Anas bin Malik. However, other historians have said that he was a *tabi al-tabiiun* (follower of followers). The Hanafi school of thought bases its interpretations

largely on *ray* or *ijtihad*, but also draws from the Quran, *Sunnah*, *ijma*, *qiyas*, and *istihsan* (in order of importance).³⁷

The Maliki school of thought derives its perspective from the work of Imam Malik bin Anas, who was born in Madinah in AD 711 and died there in AD 798. He lived all his life in Madinah (Madinah was the main center of Islamic knowledge in his lifetime) and he was from *tabi al-tabiiun*. Imam Malik used the Quran, *Sunnah*, *ijma*, and *qiyas* as base for his *fatawa*; however, he used other sources as well, such as the practices of the people of Madina, *Maslaha Mursala*, *sahaba* sayings, *sadd al-dharai*, and *istihsan*.³⁹ Furthermore, he saw that the deeds of the people of Madinah are preferred over *qiyas*.³⁷

The founder of the Shafi school of thought was Imam Muhammad bin Idris Al-Shafi, who was born in Gaza in AD 767 and died in Egypt in AD 820. Both Abu Hanifa's students, i.e., Muhammed bin Al-Hasan Al-Shibani and Imam Malik taught him. The bases of the legislation in the Shafi school of thought are the Quran, *Sunnah*, *qiyas*, and *ijma*, but Al-Shafi did not find it necessary for *hadith* to be continued (*muttasil*) and preferred *ijma* over the deeds of the people of Madina.³⁷

Ahmad bin Muhammad bin Hanbal Abu Abd Allah Al-Shaybani was the founder of the Hanbali school of thought. He was born in Baghdad in AD 780, but he traveled frequently until he settled in Baghdad, where he died in AD 855.³⁷ He studied under Imam Al-Shafi, who is widely considered the founder of Islamic jurisprudence, but later he became independent and formed his own school of thought. His school is based on the Quran and *al-hadith al-marfu* (elevated *hadith*), *sahabah fatawa* (if there any differences with *sahabah fatawa*, he chooses the *fatawa* that is more closely related to the Quran or *hadith*), weak (*daif*) and hurried (*mursal*) *hadith*, and *qiyas*.³⁷ In addition, Imam Ahmad used *istisbaab*, as did Imam Shafi in his *fatawa*.³⁹

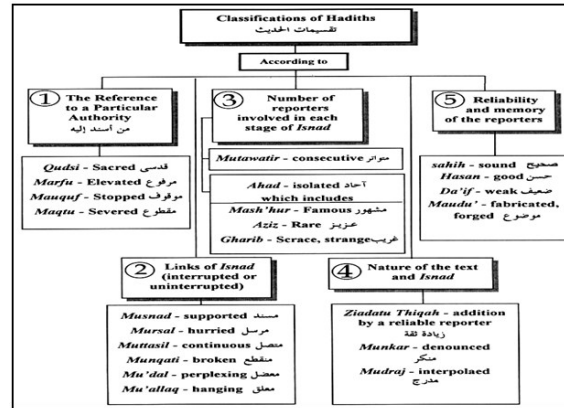


Figure 1: Classification of *Abadith*

Abadith alqudsi: Divine; the sayings of the Prophet Muhammad (s.a.w.) as revealed to him by Allah (s.w.t.).

Abadith Marfu': Elevated; attributed to the Prophet Muhammad (s.a.w.), e.g., I heard the Prophet Muhammad (s.a.w.) saying.

Abadith Mauquf: Stopped: a narration from a companion only, e.g., we were commanded to.

Abadith Maqtu': Severed: a narration from a successor.

Other schools of thought among *Sunni* Muslims had their day but ultimately did not spread like those mentioned above, for example, Al-Awzai school of thought and the *Zahiri madhhab*.

An Overview of Islamic Contracts

The law of *ibadaat* states: "everything except what is prescribed is considered prohibited". Similarly, the law of *muamalat* states: "everything is permissible except what is prohibited". *Muamalat* includes family law, criminal law and commercial law, and part of *muamalat* determines which contracts are permissible and which are prohibited by *Shari'ah*.

Principles of Islamic finance

There are six pillars that oversee the regulation and religious validity of any Islamic economic and financial activity, as follows:

- (1) Prohibition of *Riba* (Usury or Interest): Islam considers any effortless profit that is taken without exchange of goods and services to be interest or usury, some examples for transactions considered *riba* are listed in Table 3.
- (2) Prohibition of *Gharar*: in Arabic, *gharar* means risk or hazard. Also, the term denotes fraud, deception, delusiveness, peril, uncertainty, and fallaciousness. In jurisprudential terms, *gharar* means uncertainty or doubtfulness, as in not knowing whether something will take place.
- (3) Prohibition of *Mayisr* (speculation) and *Qimar* (gambling): *Mayisr* is derived from the Arabic word *yusr*, which means “ease of obtaining something of value without earning it”. Thus, any transaction that depends on uncertain event in the future like conventional insurance and derivatives are prohibited. *Mayisr* is broader in scope than *qimar*.
- (4) Materiality: all financial transactions must have ‘material finality’, that is a direct or indirect link to a real underlying economic transaction.
- (5) Risk sharing: the provider of financial capital and the entrepreneur share business risks in return for a share of the profits.

Fundamental conditions to establish a contract's validity

A contract (*aqd*; plural *uqud*) literally means “to bind,” and technically is an agreement between two persons in legally accepted, impactful and binding manner. Islam urges its followers to document all of their transactions and contracts, especially future transactions: “O’ ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing” (Al-Baqarah 2:282).

Muslim scholars explain that Islamic law contains a few general requirements for establishing the validity of contracts, as follow:

- (1) free consent of the contracting parties (i.e., there must be no coercion);
- (2) capacity (*ahliyyah*); that is, parties to any contract must be in a physically capable and mentally sane state. Therefore, people who are severely ill, have diagnosed psychological disorders, are alcoholics, are minors, and so forth cannot enter into a legal contract;
- (3) the object of the contract (*mabi*) must be existing, owned by the seller, and physically or constructively in the possession of the seller; and
- (4) the contract must have a purpose or consideration.^{11,20,46}

Table 3: Classification of *riba*²⁵

Type of <i>riba</i>	Party A gives	Party B returns
<i>Riba al-jahiliyyah</i> (Interest on credit, loan, mortgage)	Party A gives party B \$500 credit	Party B returns \$600 to Party A after a month. \$100 excess is <i>riba</i> . This is absolute form of <i>riba</i>
<i>Riba al-fadl</i> (exchange of money for money but one party receives more money in the exchange)	Party A gives Party B three bullion of gold	Party B returns six bullion of gold. The three bullions are <i>riba</i> .
<i>Riba al-nasiyah</i> (like for like, where one party delays delivery)	Party A gives 2 bullion of gold to party B	Party B returns 2 bullion of gold after 2 months. This is <i>haram</i> because price of gold may change in 2 months.
<i>Riba al-nasiyah</i> (When items differs and one party delays delivery)	Party A barter 100 tons wheat to party B who will pay 100 lbs. gold after 6 months	Party B returns 100 lbs. gold after 6 months. This is <i>haram</i> because price of gold may change. It is only allowed if both items are exchanged hand-in-hand.

Contracts classified as either valid or invalid, and to go into effect, a contract must be both valid and permissible. A valid contract satisfies all of the conditions of the contract, whereas an invalid contract does not satisfy one or more of the conditions of the contract.¹¹ For instance, selling grain or other brewing ingredients to breweries is not valid because the product would

be used to produce alcohol, which is prohibited by Islamic law. Selling segregates is another example of an invalid contract, in this case because the product is illegal, even though the contract might fulfill all other conditions required by law.

Main contract types

There are several ways to categorise contracts. Businesses most commonly do this by distinguishing between contracts of exchange, investment, charity, and security. In addition, other types do not fit into these main categories.

Contracts of exchange

An exchange contract is “a contract in which ownership of one item of wealth is exchanged for another item of wealth”.⁴⁶ The most common types of contracts in this category include sales contracts, hiring contracts, and volunteer contracts.

- (1) Sales contracts (*bay*): In Arabic, the term *bay* refers to any transaction in which ownership of an asset exchanged between two parties (seller and buyer) in return for money or a bartered item. Several types of *bay* contracts are currently in use in Islamic societies.
 - (a) *Bay al-inh* (sale and buyback) refers to an agreement that involves a sale of an asset by a first party to a second party for a deferred payment, and then followed by an immediate purchase of the same asset by the first party with a lower price. This type of sale prohibited in most legal systems (*madabb*).
 - (b) *Bay al-istisna* (contract of manufacture as working capital). Literally, *istisna* means “to request a manufacturing item,” and in practical terms, *istisna* is a contract in which the buyer requests that the seller manufacture a specific non-fungible item and permits a deferred or on-the-spot payment (payment is always deferred).⁴⁶

- (c) *Bay al-muajjal* (sale on deferred payment) is a sale in which the payment is deferred to a future time. However, the sold item must be delivered immediately. This type of sale generally permitted in *Shari'ah* and legitimised in *Surah* Al-Baqarah, where deferment is explicitly permitted.⁴⁶
- (d) *Bay al-salam* (deferred contract), also known as *bay al-salf*, can be defined as a sale of an object, which will be delivered on a fixed date in the future, with an agreed price (*ras mal al-salam*) at spot. This contract invalidates the rules of sale because the sold item does not exist at the time of contract conclusion. According to bin Abbas [ca. AD 618–687], a paternal cousin of the Prophet Muhammad (*s.a.w.*) who was revered by Muslims for his knowledge and his expertise in *Tafsir* (exegesis of the Quran), the Prophet Muhammad (*s.a.w.*) approved of *bay al-salam*. However, bin Umar (AD 614–692), the son of the second *caliph* Umar bin Khattab and a prominent authority in *hadith* and law, was of the view that such sales were not permitted in the Quran.⁴⁶ Bin Rushd summarises about condition whether the species of the *muslam fih* should be existence at the time of contract by saying that: Malik, Al-Shafi, Ahmad, Ishaq, and abu Thawr did not stipulate this and said that *salam* is permitted for a thing out its season. Abu Hanifah, his disciples, Al-Thawr and Al-Awzai said it is not permitted unless it is the season of the *muslam fih*. The proof of those who did not stipulate the season is what occurred in the tradition of bin Abbas that the people used to contract *salam* for dates for a period of two or three years. This was approved and not rejected. The reliance of Hanafites is upon the tradition related by bin Umar that the Prophet Muhammad (*s.a.w.*) said: “Do not contract *Salam* in date-palms until they (the dates) begin to ripen”.⁴⁶ In this type of contract, it is necessary to fully specify the quality of the item to be purchased, leaving no ambiguity that could

lead to dispute. This type of *bay* also applies to fungible commodities.

- (e) *Bay al-sarf* (currency trading) is a contractual exchange of money for money. Modern scholars have approved of trading of currencies on the basis that, in the days of the Prophet Muhammad (*s.a.w.*), gold traded for silver.⁴⁶
- (f) *Bay al-tawarruq* (substitute asset backing a loan). The term *al-tawarruq* originated from the word *wariq* (paper), which translates as dirham coined from silver. *Tawarruq* technically means buying a commodity at a deferred price, and then sells it for cash to another party (i.e., usually at a lesser price than the original purchase price). There are different opinions regarding *tawarruq* contracts. Islamic scholars bin Taymiyah, bin Qayyim, Imam Ahmad (one of his two versions), and Imam Malaik argued that the practice was not permissible, whereas Al-Shafi and the majority of the Hanafi jurists have allowed it.¹² In contrast, Imam Ahmad (one of its two versions) and some of the Hanafi jurists said that *tawarruq* is abominable.¹³ Thus, the majority of jurists have not prohibited this practice. In addition, in the 15th conference of the Islamic *Fiqh* Academy (an OIC initiative in Makkah, Saudi Arabia on October 21, 1998), the academy declared that *tawarruq* was permissible. In many Islamic countries today, there are two types of *tawarruq*: organised *tawarruq* (*al-tawarruq al-munazam*) and *al-tawarruq al-masrifi*. Organised *tawarruq* is when a buyer purchases a commodity on credit and then immediately sells the commodity to a third party to obtain cash.¹³ This type of *tawarruq* often referred to as traditional or real *tawarruq*. The second type, *al-tawarruq al-masrifi*, is the same as *al-tawarruq al-munazam* but occurs through a financial institution, such as an Islamic bank. In the 19th session of the Islamic *Fiqh* Academy (in Sharjah, United Arab Emirates on April 20–26, 2009) prohibited organised *tawarruq* (*al-tawarruq al-masrifi*). The difference between *bay al-inah* and *tawarruq* is that

the former consists of two parties (the seller and the buyer), whereas in *tawarruq* there are three parties (seller, buyer, and a third party).

- (g) *Bay al-murabahah* (sale with a markup) derives from the Arabic word *ribah*, which means profit. *Bay al-murabahah* is a sale in which the seller buys a commodity, such as a house, and marks up the price.⁴⁶ For the sale to be legal, the buyer has to be informed of the profit margin and must agree to the price. If the cost of the original purchase is not disclosed, then the sale is known as *bay al-musawamah*.⁴⁶ In recent years, Islamic banks have begun to use a type of *murabahah* called *al-murabahah li al-amir bi al-shira* (*murabahah* to the purchase order). This involves two sales: a cash purchase for goods by the bank with a promise that the client will purchase the goods from the bank (usually Islamic banks use a binding bilateral promise), followed by a *murabahah* sale of those same goods by the bank to the client on a deferred settlement term.⁴⁶ The majority of contemporary scholars, such as Shaykh Yusuf Al-Qardawi, argues that this practice is permissible.⁴⁶ The difference between the bank's *bay al-murabahah* purchase and the buyer's *murabahah* purchase is that the bank makes the sale to the buyer without actually owning the commodity in question, whereas the commodity's original owner does possess the commodity when selling it to the bank.
- (h) *Bay al-urbun* (call option) can be translated into English as a down-payment sale. *Urbun* refers to a transaction whereby the buyer deposits part of the purchased price with the seller in advance and agrees that if he fails to fulfill the contract the seller will keep the deposited amount. The only school of thought that validates this sale is Hanbali, which based on a *hadith* narrated by Abd Al-Razzaq in his book *Musannaf*. In this *hadith*, Abd Al-Razzaq argues that the Prophet Muhammad (*s.a.w.*) permitted the down-payment sale (although this *hadith*

regarded as weak).⁴⁶

- (i) *Bay al-wafa* (debt guarantee sale) is a contract whereby the seller of an asset has the right to repurchase the asset with the same price from the buyer. This sale contract has various names, including *al-uhadah* (custody sale), *bay al-idah* or *bay al-wad* (promise sale), *bay al-amanah* (trust sale), *bay al-nass* (people's sale), and *al-bay al-jaaiz* (allowed sale). This type of sale is invalid according to the majority of scholars, and this is the prevailing view of Maliki scholars, Hanbali scholars, and the early scholars from the Hanafi and Shafi schools. In addition, in the closing statement of the seventh Islamic *Fiqh* Academy conference (in Jeddah, Saudi Arabia on May 14–19, 1992), this type of sale was discouraged.³⁶
- (2) *Ijarah* (hiring contract): The literal translation of this term is to rent or lease something. In Islamic jurisprudence, the term *ijarah* has two different connotations. The first, a hiring contract, means, to employ the services of a person with a known wage as a consideration for his/her hired services. The second, a lease contract which can be defined as a transfer of ownership of permitted usufruct to another person in exchange for known compensation. One definition of *ijarah* from the Hanafi school of thought is: "a contract that enables possession of a particular intended usufruct of the leased asset (*ayn*) for a consideration". Today, *ijarah* has become a financing tool which commonly known as *ijarah muntahia bi ttamleek* (IMB; also known as *ijarah wa iqtina*), which is a lease that ends with the ownership of the asset. There are several forms of IMB: IMB through a gift (at the end of the period and when installments have been settled the legal title of the asset is transferred to the lessee free of charge), IMB through gradual transfer of the title (title of the asset is transferred gradually during the period of the contact to the lessee), and IMB through remaining *ijarah* installments (title of the asset is transferred to the lessee at any time, with a transfer amount that is equal to the remaining *ijarah* installment).

- (3) *Jualah* (work done for reward; commission): *Jualah* is a type of contract in which one party (the *jail*) offers a specific reward (*jual*) to anyone who may be able to achieve a predetermined work. An example of this type of work would be if a person paid someone \$1,000 for finding his stolen car.

Contracts of investment

There are several investment contracts and the following are the most common.

- (1) *Musharakah* (partnership): *Musharakah* is a word of Arabic origin that literally means joint participation. In business terms, the idea translates to a partnership between two parties that provide capital to finance a project. Any profits are split according to a prearranged agreement, whereas any losses are shared according to the capital contributed.⁴⁶ There are three categories of *musharakah* contracts as follows:³⁴
- (a) *Shirkat al-milk* (co-ownership): This type of contract refers to joint ownership of two or more persons in a particular property.
- (b) *Shirkat al-aqd* (contractual partnership): This means a “partnership affected by a mutual contract”. There are three specific types of contractual partnerships.
- (i) *Shirkat al-amwal*: All the partners invest some capital into a commercial enterprise.
- (ii) *Shirkat al-abdaan*: Two or more partners agree to work together in a business and share profits and losses according to a pre-agreed ratio.
- (iii) *Shirkat al-wujooh*: Two or more individuals use their high credit ratings as a basis for engaging in business. For example, they purchase commodities on deferred payment plans and sell them at higher prices.
- (c) *Musharakah mutanakisah* (diminishing *musharakah*): In this type of agreement, the capital provider and his client participate in joint ownership of a property or equipment or in a joint commercial enterprise. The

financier's share is purchased on a periodic basis by a client based on an agreement between the two parties. Thus, the client will own increasing shares until the client purchases all of the financier's shares and becomes the sole owner of the property or the commercial enterprise, as the case may be.²⁹

- (2) *Mudarabah* (silent partnership): *Mudarabah* is a form of partnership in which one party provides the funds (*rabb al-mal*) and the other provides the expertise and management (*mudarib*). The profits shared between both parties on a pre-agreed basis, whereas any losses are borne by the provider of the capital. The *mudarib* must not receive any salary for his work because the essence of this contract is to share profit.^{27,46} The term *al-mudarabah* is chosen by Hanafi and Hanbali jurists, whereas Maliki and Shafi jurists used the term *al-qirad*, and contemporary scholars use both terms. Regarding the legality of *mudarabah*, Al-Marghinani says in his book 'Al-Hidaya': "There is no difference of opinion among the Muslims about the legality of *qirad*. It was an institution in the pre-Islamic period and Islam confirmed it. They all agree that the nature of the *mudarabah* business is that a person gives to another person some capital that he uses in the business. The user gets, according to conditions, some specified proportion, e.g., one-third, one-fourth or even one-half".²⁷

Security contracts (tawthiqat)

The main concern of these contracts is protecting the interest of the parties involved in the contract. The important types of security contracts are listed below.

- (1) *Rahn*: *Rahn* translates as "constancy" or "holding. In English this term can be translated as "pawn," "pledge," or "mortgage".⁴⁶ The Quran states: "Every soul will be (held) in pledge for its deeds" (Al-Muddaththir 74:28). *Rahn* is used to protect and preserve wealth, and this is clearly stated in the Quran: "And if you are on a journey and cannot find a scribe, then let there be a pledge taken (mortgaging); then if one of you entrust the

other, let the one who is entrusted discharge his trust (faithfully), and let him be afraid of Allah, his Lord. And conceal not the evidence for he, who hides it, surely his heart is sinful. And Allah is All-Knower of what you do” (Al-Baqarah 2:283). The above verse emphasises that Muslims must provide proof and security for a credit transaction in the form of written documents, witness testimonies, or property deposits as a pledge. In a *hadith* narrated by Aisha (*r.a.*), she said: “The Prophet bought some food grains on credit from a Jew and kept his iron armor or shield as pledge”.¹⁴

- (2) *Kafalah* contracts: In Arabic, *kafalah* means guarantee. It can also be defined as: “a guarantee given to a creditor that the debtor will pay the debt, fine or any other liability”.²⁷ In modern days, *kafalah* has been used widely by Islamic banks in issuing letters and documentation of client credit. There is much evidence supporting the use of *kafalah* in *hadith* narratives; for instance, according to Salamah Al-Akwa, the Prophet Muhammad (*s.a.w.*) was presented with a corpse of a man to be preyed upon (before the burial). He asked, “Did he leave anything?” They answered, “Nothing at all!” He asked, “Does he owe anything?” They answered, “Yes indeed, he owes two gold dinars.” He said, “Proceed with the funeral prayer with your friend (without me)”. Abu Qatadah said: “O’ the messenger of Allah, I will be guarantor (for their payment) of those two dinars”. After that, the Prophet Muhammad (*s.a.w.*) performed the funeral prayer for him”.¹⁴

Contracts of charity

There are two main types of charity contracts in modern Islamic society: *qard* and *hibah*.

- (1) *Qard*: In Arabic the term *qard* means “cutting of a piece”. The term used in business when property is cut off, or transferred to the borrower.^{27,46} *Qard* is seen by Hanafi jurists as “a sale of an item now in return for counter value which takes the form of the same item to be paid later”.⁴⁶ The Quran approves of and recommends giving a *qard hasan* (benevolent or charitable

loan) in many verses; in one such verse, Allah (*s.w.t.*) said: "Who is he that will lend to Allah a goodly loan so that He may multiply it to him many times? And it is Allah that decreases or increases (your provisions), and unto Him you shall return" (Al-Baqarah 2:245). The terms *qard* and debt are different, and this can be found in the words of Egyptian Syed Mohammad Tantawi the former head of Al-Azhar University: "*Qard* (as a term) is more particular than *Dayn*, as it is that loan which a person gives to another as help, charity or an advance for a certain time ... A *Dayn* is incurred either by way of rent or sale or purchase or in any other way which leaves it as a debt to another. *Duyun* (debts) ought to be returned without any profit since they are advanced to help the needy and meet their demands and, therefore, the lender should not impose on the borrower more than what he had lent".²⁷ On the other hand, *qard* is a particular type of *salaf*, and the latter literally means a loan that draws forth no profit for the creditor.²⁷

- (2) *Hibah*: *Hibah* means gift and this kind of contract is defined as: "a contract which results in a voluntary transfer of ownership of an item without receipt of a counter value by the donor".⁴⁶

Other forms of contracts

Many other types of contracts are used in Islamic society, and three most common and relevant to this study are, i.e., *wakalah* (agency), *hawalah* (assignment of debt), and *wadiyah* (deposit).

- (1) *Wakalah*: It literally means "is looking after", i.e., taking custody, applying a skill, or remedying a situation on behalf of others.²⁷ The word *wakil* is derived from *wakalah* and is used in the Quran to mean protector or preserver. However, the term agency is commonly used in modern translations, especially in commercial usage.⁴⁶ The Quran says: "(He Alone is) the Lord of the east and the west; none has the right to be worshipped but He. So take Him Alone as Disposer of your affairs" (Al-Muzzammil 73:9). In this sense, the bank acts as an agent for its clients in completing a particular financial

- transaction, and the bank will earn a fee on its services. This is known as *wakalah bi-al ajr* (agency with a fee).
- (2) *Hawalab*: *Hawalab* “implies the transfer of something from one person to another or from one situation to another”.²⁷ In Islamic business law, *hawalah* is defined as “the transfer of liability for a debt to a creditor”.⁴⁶ The validity of *hawalah* can be inferred from the *hadith* narrated by Abu Hurayrah: “The Prophet said procrastination in the payment of debts by a wealthy man is an injustice. So if your debt is transferred from your debtor to a rich debtor, you should agree”.⁴⁶
- (3) *Wadiah*: *Wadiah* is a safekeeping contract based on the principle of trust. In this type of contract, the deposit holders not allowed to use the deposited funds without the permission of the depositor. In modern Islamic banks, this contract is used for savings and checking accounts whereby an agreement is signed between the customer and the bank that allows the bank to make use of the deposited funds (the funds are guaranteed by the bank).

ISLAMIC BANKING OPERATIONS

Sources of Funds of Islamic Banks

Conventional banks use the financial resources in their operations to make a profit, considering the factors of liquidity and risk and a set of rules and regulations that govern these processes. In that sense, Islamic banks are no different. The sources of funds for Islamic banks are very similar to those of their counterparts and include internal, external, and other sources.

Internal sources of funds

These sources do differ from conventional banks in terms of their importance and purpose. This source includes paid capital, reserves, and retained profits. Capital is the main source of funds for banks. Also, this source plays an important role in absorbing any financial stresses that might affect the bank's operations. Conventionally, capital can be issued in the form of common stocks or preferred

stocks. However, Islamic banks can use common stocks only because preferred stocks have a fixed rate of dividends, and this is prohibited in Islamic principles. Furthermore, the minimum capital requirement of Islamic banks is higher than the minimum requirement for conventional banks because the goals of Islamic banks revolve around development, investment, establishment of projects, and so forth. This requires long-term funding, which eventually led Islamic banks to have higher capital. Actually, in many countries, such as Lebanon and Syria, the initial capital required of Islamic banks is higher than that of conventional banks.

Reserves are a specific amount deducted from the bank's net income to strengthen the bank's overall financial position. There are several forms of reserves. Mandatory reserves are a percentage of the bank's profits. By law, mandatory reserves must be kept within the bank and are not to be distributed to shareholders. This percentage is determined by the central bank for each company. Nonobligatory reserves are optional, and the amount is proposed by the Bank's Board of Directors to the general assembly when the bank has enough profit. Non-obligatory reserves are used for purposes proposed by the board and may be distributed entirely or partly to the shareholders if not used for those purposes.

In addition to mandatory and non-obligatory reserves, laws and accounting practices for banks generally require them to hold reserves for doubtful loans. Each bank must retain a certain amount of money to meet any losses that may occur in relation to those loans. This limit differs from one country to another. Retained profits are profits generated by the bank and are not distributed to shareholders. Retained profits can be used by banks to expand their activities and finance new investments.

External sources of funds

These sources come to the bank from parties other than shareholders. The external resources of Islamic banks are similar to the external resources of conventional banks in form but different in terms of goals. Deposits are the most important external source, and in Islamic banks, they tend to be used differently than they

are in conventional banks. The general rule is that Islamic banks receive deposits on the basis of loan not on the basis of *wadi'ah*. This is because Islamic banks can use these deposits and benefit from the return on them, but in the case of losses the bank is obligated to return these deposits to the depositors. This is based on an Islamic legal regulation called *al-karaj bi al-daman*.⁷ Deposits in Islamic banks are divided into many areas, as discussed below.

Checking accounts allow the depositor to withdraw or deposit any amount at any time. Furthermore, the depositor can benefit from the bank's facilities, such as by receiving a checkbook, cash transaction, and so forth, with a fee. There is no difference between conventional and Islamic banks regarding this type of account, as neither offers a return on funds in these accounts. However, Islamic banks cannot use money in checking accounts without permission from the depositor.

Saving accounts are generally small and offered by banks to encourage small savers to invest. For these types of accounts, conventional banks differ from Islamic banks because the latter do not give a predetermined return on them. However, account holders receive a portion from the profit, which is calculated based on the minimum balance for the account, considering the available liquidity of the bank. Liquidity must be considered because the holders of saving accounts can withdraw part or all their deposits after the bank have been notified a week or more in advance, depending on the agreed period. Islamic banks usually use the deposits in saving accounts in short-term investment projects.

Investment accounts correspond to time deposits in conventional banks. Islamic banks invest these deposits according to a loss-and-profit scheme. Investments are made in mid and long-term projects and can be divided into two types: general investment accounts and restricted investment accounts.

General investment accounts include participation in all the investment operations of the bank. In this case, the depositor will be a partner with the bank in its investment activities according to the amount he invested and the period of investment. The profit distribution rate is predetermined, and this is in line with Islamic principles. However, if both parties agree on a different

rate for the distribution of profits according to their level of earnings, the new rate is permissible.

Restricted investment accounts, clients restrict their investment to certain projects from a portfolio of projects offered them by the Islamic bank. The return on the investment account is much higher than the returns from saving accounts because the invested amounts are larger.

Issuing *sukuk* (bonds), *sukuk* can be defined as *Shari'ah* compliant bonds, and in their simplest form, they represent ownership of an asset or its usufruct. The claim embodied in *sukuk* is not simply a claim cash flow but ownership as well. Banks issue several types of *sukuk* to raise funds, and some of the most common forms of *sukuk* are listed below.

- (1) Investment *sukuk* is based on the principle of *mudarabah*. Funds are provided by the *sukuk* holders, and the management or work will be provided by another party (the bank). Investment *sukuk* takes one of the following forms.²³
 - (a) Investment *sukuk* earmarked for a specific project: This form is based on restricted *mudarabah*. The bank's owners choose a project that they are willing to fund. They issue investment *sukuk* for this project and offer them to the public. The duration of the *sukuk* is determined by the duration of the project. The profit is distributed every 3 or 6 months, and the final settlement occurs at the end of the project. The bank receives a portion of the profit and its share is determined in advance.
 - (b) Investment *sukuk* allocated to a particular activity: In this type, the bank's owners select an activity (a business, real estate, industrial, or agricultural) and then issue investment *sukuk* for these activities and offer them to the public. The duration of the *sukuk* ranges from 1 to 3 years, depending on the type of activity. The profit is distributed every 3 or 6 months, and the settlement occurs annually based on the financial position of the activity. The bank receives part of the profits, the amount of which is determined by *sak*.

- (2) *Sukuk al-muqaradah* is an investment type produced by Jordan Islamic banks. This type of investment can be divided into two types.
- (a) *Sukuk al-muqaradah al-mushtarakh*: This type of investment *sukuk* is issued by a bank at a specified face value and is offered to the public to raise bank funds to finance investment projects. Part of the net profits generated from those investments is distributed to the *sukuk* holders. The distributed profits differ from year to year based on the outcome of the investments. This type of *sukuk* is directed to small investors.
 - (b) *Sukuk al-muqaradah al-mukasash*: In this type of investment *sukuk*, the bank's owners choose particular projects, issue *sukuk* for each project, and allow investors to invest in the project of their choice. In this case, the bank acts as an agent for the investors.

Other sources of funds

Islamic banks offer non-credit services to their clients in exchange for a commission, which provides extra income to the bank. These services adhere to Islamic principles. The most important services offered by Islamic banks are as follows.

Letters of credit are called *kafalah*, and they are issued mostly by banks and used primarily in trade finance to ensure that payment will be received. Islamic banks offer this service to their customers on the basis of *wakalah bi-al ajr*.

Documentary credits are a statement of payment for the exporter (beneficiary) and are published by the issuing bank based on the requirement that the importer fulfill certain conditions. Documentary credits are handled in Islamic banks in two ways. The first method is to open documentary credit fully funded by the customer. The process is mostly similar to the process used in conventional banks, with one major difference. When the credit is not fully covered by the customer, the bank will collect interest on the amount not covered, and this interest is avoided in Islamic banks. Islamic banks do not pay interest on cash deposits received at the time the credit line is opened, nor do

they collect interest from the customer in case of late payment because either of these practices would be considered *qarad hasan*. The second method is to open documentary credit that is entirely or partly financed by the bank. Financing takes several forms.

Financing on the basis of *murabahah* is a purchase-order scheme used widely by Islamic banks. In this scheme, the client signs a contract with the Islamic banks in which the client requests or orders the bank to purchase a specific product with a promise to buy it. When the product is received, a sales contract is signed, and Islamic banks are committed to the beneficiary of the credit.

Financing on the basis of *murabahah* is a scheme in which the client and the Islamic bank are partners (the Islamic bank by capital and the client by effort). The profit is divided according to the agreement between both parties. However, any losses are borne only by the owner of the capital (i.e., the bank), unless it is proven that the customer caused the loss.

Financing on the basis of *musharakah* is a scheme in which the capital is provided by the Islamic bank and the client. The profit is distributed according to the agreement between the bank and the client, and loss is assumed based on each party's percentage of contribution to the capital.

Islamic banks can collect and accept commercial papers and collect fees on them. On the other hand, the discount of commercial papers is a matter of controversy among Muslim scholars. The discount of commercial papers is called *da wa tajal* (also known as *al-hateth*). Most scholars argue that the practice is prohibited in Islamic law.

Currency-exchange or foreign-exchange transactions are one of the most important banking services in many countries, especially in the field of documentary credits and the payments of financial obligations in various currencies to foreign banks. In Islamic finance law, these transactions are permissible, and most Islamic legal scholars agree, as long as the exchange is done on the spot and the two currencies are valued differently. Also, Islamic banks are allowed to collect fees on those transactions and benefit from the difference of the value between the two currencies.

Credit cards are a service under great debate. There are two opinions in Islamic thought regarding credit cards. The first opinion is that they are permissible as long as no interest needs to be paid on the delayed amount. The second opinion is that they are forbidden because they represent a contract with a conditional-interest clause. The consensus seems to be that it is unlawful to collect interest on credit-card debt. However, the fees for issuing the cards are lawful. There are different types of credit cards, and each has its own set of rules for legal use in Islamic finance.¹³

Debit cards are more widely accepted. These cards are issued to customers who hold accounts with the bank and can use them around the clock to withdraw cash or purchase domestic and international goods. Islamic banks may issue such cards as long as the cards do not create any increase in a loan and can only be used by the client to pull from his or her own account.

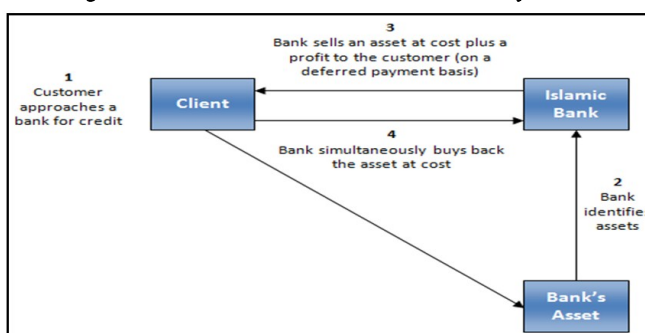
Charge cards or discount cards has a limit, and the cardholder is required to pay the entire balance in full each month. This type of card is prohibited because it involves *riba*. However, it is permissible for Islamic banks to issue charge cards on the following conditions: the bank will not request the cardholder to pay interest if the payment is delayed; and if the bank requests a deposit from the cardholder as a guarantee, the bank will invest this amount on the basis of *mudarabah* and the profit will be shared by both parties.

Revolving credit cards are another type of card with a limit. However, the cardholder can pay the monthly amount due on the card in several installments, and the issuing bank will receive an interest on those installments. Revolving credit cards are the most common card in the world and include, notably, Visa and MasterCard. These cards are illegal in Islamic societies, but some alternatives are available that do adhere to Islamic principles, such as *tawarruq* cards. According to Messay,¹⁵ Islamic credit cards need to meet at least three criteria:

- (1) The card must not use *riba*, *gharar*, or *maysir*;
- (2) The card must be accepted widely throughout the country;
and
- (3) The card must not encourage behavior that is considered haram.

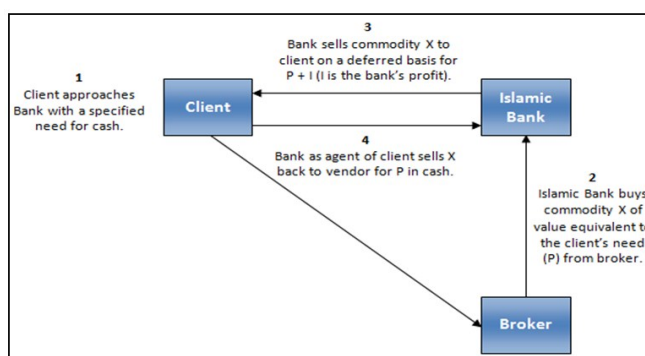
The majority of credit cards issued by Islamic banks based on five *Shari'ah* compliant contract models: *bay al-inh*, *tawarruq*, *ijarah*, *ujra*, and *kafalah*. Many credit cards issued by Islamic banks in Southeast Asia, especially in Malaysia, are based on a *bay al-inh* model (*bay al-inh* prohibited by majority of jurists). Figure 2 shows the *bay al-inh* process.

Figure 2: Credit-card transactions based on *bay al-inh*³



Another approach is the *tawarruq* model. This model has been used by Islamic banks in the Middle East, especially in GCC (Gulf Cooperation Council) countries. The difference between the two models is that, in a *tawarruq* transaction, a third takes the bank's role as a buyer. Figure 3 shows the *tawarruq* process.

Figure 3: Credit-card transactions based on *bay al-tawarruq*³



Another type of transaction is *hawalah* transfers. These are transfers in which Islamic banks transfer funds for a customer at the customer's request to other financial institutions within the country or abroad. The bank charges a fee for this service.

Uses of Funds by Islamic Banks

Islamic banks mobilise their funds in different ways from that of conventional banks. The uses of the funds in Islamic banks take several general forms.

Cash assets

Islamic and conventional banks use it in the same way except that Islamic banks do not generate any return on them. Additionally, Islamic banks usually hold more liquid assets than do conventional banks. Therefore, Islamic banks are more liquid than mainstream banks because Islamic interbank money markets are still not well developed.

Restricted investment accounts

The contractual relationship between the bank and account holders can take the form of *mudarabah* or *wakalh*. In *mudarabah* contracts, the investor (*rabb al-maal*) provides the capital, and the bank provides the expertise. Management and work is the responsibility of the bank. The profit is distributed per the agreement between the bank and the account holder. However, the loss is borne by the account holder if there is no negligence on the bank's part. *Wakalh* contracts are slightly different: There must be an agreement between the contracting parties on the fee amount that the bank will receive regardless of whether there is a profit.

Qard hasan loans

These type of loans are categorised into two types depending on their purpose. Social loans meet urgent social needs (illness, death, education, and housing). Productivity loans are provided to small craftsmen and workers to help them be productive members of society and generate enough income from their activities to meet their needs (with the surplus used to pay back the loan).

Direct investment

Islamic banks can invest directly in any project. Some examples of direct investment include acquiring shares in other companies and purchasing goods or assets and later renting or selling them for profit. Banks can also establish productive projects, and the revenues of these projects can be a source of income for the bank.

Indirect investment

In an indirect investment, the bank enters into a contractual relationship with any legal entity to establish a project or participate in an existing project. The role of the Islamic bank is determined by the capital it contributes and by the extent of its participation in the project's management. There are several forms of indirect investments. The most important are *mudarabah* contracts, *musharakah* contracts, *al-murabahah* contracts, *bay al-istisna* contracts, and *bay al-salam* contracts.

However, the *Shari'ah* principles applied by Islamic banks in providing their products and services to their clients differ from one country to another. There are several reasons for this variation.⁴² First, the laws that govern Islamic banks are different in each country. For example, the religious authority that is responsible for monitoring and supervising the activities of Islamic banks differs between countries. Second, there is no organisation or body that has the authority to monitor and supervise the operations of all Islamic banks throughout the world.

CENTRAL BANKS' SUPERVISION OF ISLAMIC BANKS

The first public bank to offer accounts not directly converted to coin was the Bank of Amsterdam, or Amsterdamsche Wisselbank, which was founded in 1609. For this reason, the Bank of Amsterdam can be described as the first true central bank.⁴ This was followed by the establishment of the Bank of England in 1694, whose primary purpose was to raise money and lend it to the state; for that service, the bank was allowed the privilege of issuing bank notes.¹¹ Many of the central banks around the world were established in the early 1900s. This was mainly because of the

decision of the Brussels Summit in 1920, which urged countries that had not already established a central bank to found one.¹⁷ Establishing a central bank was a necessity in the light of increased economic activity among the people and increasing funding needs of governments. The objective of the central banks was to regulate monetary policy, supervise all other banks (Islamic banks, commercial banks, credit banks, etc.), and manage the balance of payments.

The relationship between a central bank and Islamic banks varies across countries and banking systems.^{5,17,21} In countries where the central bank and the entire financial system are Islamic (e.g., Iran and Sudan), Islamic banks have a harmonic, seamless relationship with the central bank. In other countries, Islamic banks must follow specific rules and regulations to be able to operate side by side with conventional banks in a dual system such as in Malaysia, Turkey, and the UAE. In some countries, Islamic banks are allowed to operate but are not allowed to practice some important *Shari'ah* practices (e.g., Egypt and the Philippines). For instance, banks might be forced to use interest-bearing accounts, which violate Islamic law. Yet another system occurs when Islamic banks operate under the same laws and regulations that govern the conventional banks in the country (e.g., Denmark), and in these cases Islamic banks have very little freedom to use financial practices that are consistent with Islamic law. The regulation, supervision, and control of Islamic banks by central banks raise a number of serious issues.^{5,17} Several of these issues are noted below:

- (1) The same license requirements used for conventional banks are sometimes applied to the Islamic banks;
- (2) The same statutory reserve, capital adequacy, and liquidity ratios are sometimes applied to Islamic banks;
- (3) Some central banks force Islamic banks to deposit a proportion of foreign-currency deposit holds with a fixed interest rate;
- (4) The same credit ceiling for conventional banks is sometimes applied to Islamic banks;
- (5) Some legislation prevents Islamic banks from conducting

activities per Islamic banking operations, such as owning real estate, trading wholesale or retail goods, importing or exporting goods, possessing equipment or machinery or renting it and then lending it to others, and so forth;

- (6) The same supervision procedures and regulations are sometimes applied to Islamic banks;
- (7) A bank cannot give a client a loan that exceeds a specific proportion of the bank's paid-up capital and reserves;
- (8) Some countries prohibit Islamic banks from discounting commercial papers;
- (9) Some countries prohibit Islamic banks from using the central bank as the lender of last resort;
- (10) In some countries, Islamic banks must apply the same banking-service fees that the conventional banks use; and
- (11) Islamic banks are sometimes required to prepare their reports using the same forms as conventional banks. Hence, investment accounts based on profit-loss sharing are classified as a fixed-term deposit.

Below is an elaboration on some of the above-mentioned issues with recommendations to overcome them.

Reserve Requirements

The reserve requirement is one of the monetary policy tools used by a central bank to control the money supply and credit in an economy. Furthermore, the reserve requirement is used to protect the depositors' money and provide liquidity to the banks in times of need. The central bank demands that other banks hold a percentage of its deposits. This percentage could be, for instance, 5%, 10%, or 20%. Normally the central bank pays interest on those deposits, and because Islamic banks do not deal with interest, they must do without a basic capital stream that is available to conventional banks. The opinions on this issue in the Islamic banking literature are divided into three areas: maintaining a full reserve of 100%, applying the reserve requirements to checking accounts only, and implementing the same reserve requirements that are applied to conventional banks.¹⁷

Although the third opinion has been adopted by many central banks around the world,¹⁸ some central banks, such as the Bank of Bangladesh, have lower reserve requirements for Islamic banks. Similarly, a reserve requirement on Islamic banks' investment accounts (based on a profit-loss scheme) prevents them from fully utilising those accounts. For this reason, some researchers argue that if a central bank applies a stationary reserve requirement on the investment accounts of Islamic banks, a mechanism should be developed that allows Islamic banks to receive a return on the reserve using any schemes that adhere to *Shari'ah* principles. This is in the case in Malaysia, Bahrain, and Kuwait.

Liquidity Requirements

There are three types of liquid assets in banks. First, highly liquid assets, such as cash and bank reserves with a central bank, generate assets without profit. Second, semi-liquid assets such as government bonds and discount papers generate some profit and can be converted to cash with small losses. Finally, low liquid assets generate high profits but are difficult to convert to cash. Central banks tend to calculate the liquidity ratio for other banks with highly liquid assets or semi-liquid assets. This causes problems for Islamic banks because the calculations do not include many of the instruments mentioned above, such as government bonds. Thus, Islamic banks are not able to utilise a significant amount of its deposits to generate profits. Therefore, some Islamic bankers, such as the CEO of the Jordan Islamic Bank, suggests replacing government bonds with shares when calculating the liquidity requirements for Islamic banks.^{17,33}

Lender of Last Resort

Central banks are considered the lender of last resort for the entire banking system because they are always ready to help banks during crisis. However, central banks take returns on the loans they give to banks. This type of agreement is prohibited in Islamic law and thus Islamic banks are unable to take advantage of loans from the central bank in cases of crisis. There are a few alternatives to bailout loans:

- (1) Central banks can provide funding to Islamic banks using *mudarabah* or *musharakah* contracts;
- (2) Central banks can offer a loan without interest (*quard hasan*) to Islamic banks;
- (3) A deposit insurance scheme that adheres to *Shari'ah* principles can be established; and
- (4) The required reserves that are deducted from the investment accounts can be used to provide funding for Islamic banks in times of distress.¹⁷

Rediscount Rate

This is a tool used by central banks to control the credit volume extended by commercial banks. The process is interest based. This requires Islamic banks to hold highly liquid assets to meet any obligations. For example, there should be a pre-agreement between central banks and Islamic banks that central banks will not receive interest on rediscount transactions. However, when receiving commercial papers from Islamic banks, central banks should consider the transaction as a guarantee for the loans offered and not take interest on the papers when they are liquidated.¹⁷ In addition, central banks could use mechanisms that adhere to *Shari'ah* principles to provide funding for Islamic banks. As an example of this, the central banks of Bangladesh and Mauritania adopted mechanisms that adhered to *Shari'ah* principles to provide funds to Islamic banks.⁵

Control of Credit

Central banks usually set a ceiling for the total credit offered by each bank. In Islamic banks, this limit should be applied to the bank's debt, not to direct investments or the assets owned by Islamic banks, such as shares in companies.¹⁷ The discussion above shows that Islamic banks cannot operate efficiently, especially in a dual-bank system, because central banks use the same regulations for Islamic and conventional banks. This not only gives an advantage to conventional banks but also diminishes the role that Islamic

banks can play in the nation's economic development. Thus, it is important for central banks to understand the operations of Islamic banks so that they can develop more appropriate instruments to regulate them.

SHARIAH SUPERVISION OF ISLAMIC BANKS

Islamic banks are not only supervised by the government but also by a *Shari'ah* board or *Shari'ah* committee, and the latter ensures that Islamic banks adhere to Islamic principles. The AAOIFI defined a *Shari'ah* supervisory board as an independent body of specialised jurists in *fiqhal-muamalat*. However, the *Shari'ah* supervisory board may include a member other than those specialised in *fiqhal-muamalat* but who should be an expert in the field of Islamic financial institutions and with knowledge of *fiqhal-muamalat*. The *Shari'ah* supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution to ensure that they are in compliance with Islamic *Shari'ah* rules and principles. The *fatawas* and rulings of the Board shall be binding on the Islamic financial institution.⁶

A *Shari'ah* board ensures *Shari'ah* compliance in all Islamic bank transactions. According to the AAOIFI, the duties of the *Shari'ah* board or council are to bring about mutual conformity or approximation between the conceptualisations and the practical applications of *Shari'ah* supervisory boards of Islamic financial institutions so as to avoid inconsistencies and contradictions between the *fatawa* and the implementations of these institutions in ways that lead to the effectiveness of the role of *Shari'ah* supervisory boards in Islamic financial institutions and central banks.²⁶

Thus, the *Shari'ah* board has two rules: (1) to determine whether any new transaction or product introduced by the Islamic bank complies with *Shari'ah*, and (2) to review the current operations of the Islamic bank to ensure that it adheres to *Shari'ah*. According to Shaykh Yusuf DeLorenzo, a US-based *Shari'ah* scholar, if a product or service has not been certified by the *Shari'ah*

supervisory board, the product is considered dubious. In that case, it is up to the investor or customer to determine whether the product complies with *Shari'ah* principles and precepts.¹⁶

CONCLUSION

The practice of Islamic finance significantly departs from its theory. The current Islamic financial transactions are, in many ways, similar to those of conventional banks that based on interest. The main argument by the practitioners and supports of Islamic finance is that Islamic finance instruments are interest free as without interest the banking system is adhering to Islamic law. There are other principles that must be observed in order for any financial system to be accepted as a practice according to the Islamic teaching. At any rate, policy makers and regulators must create a *Shari'ah* compliant environment that allow Islamic banks to operate efficiently as the current environment forces Islamic banks to mimic conventional banks products.

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