ISLAMIC BANKING: AN ALTERNATIVE APPROACH

-Dr. Masroor Ahmad Beg
Associate Professor Zakir Hussain College
University of Delhi

Abstract

Islamic banking is misunderstood by the most people, as it is not based only on religious parameters. The fact does not commensurate with the general belief of the people. This paper endeavors to discover the rationale of Islamic banking as an alternative approach to conventional banking. The banking system wherein interest as an element of riba or usury has to be eliminated completely and alternative forms of banking has to substitute, meeting the intent of Islamic Sharia'. In this paper an attempt has been made to evolve that banking system which is based on Sharia' and also ensure profitability to both the investors as well as the banker. To culminate the task, this paper has been divided into two parts. Part one acquaint with the general legal framework of Islam that govern the banking practices. The second part of this paper deals with the operationalization of the banks to conduct business activities not only in the Muslim countries but also in those countries where most of the population belongs even to non-Muslim communities.

Introduction:

As compared to conventional banking, Islamic banking happened to be very young in its conception. Interest to be charged as a reward for parting with liquidity was not acceptable to Islam since it came into being. Islam is not a new religion as believed by many. According to Islam, it has been there even since the time of Adam (peace be upon him) who is considered the first human and not beginning in the 7th century. Nevertheless, it cannot be refuted that Islamic injunctions were reveled with full force just fourteen hundred years back, but the concept of Islamic banking is a subject matter of few decades. A pertinent question arises to the Islamic scholars as why it has taken so many years to evolve the Islamic banking as an alternative approach to the conventional banking? As a result, much of the literature on Islamic banking has grown out of a concern that how the monetary and banking system would function without involving interest. Even the concept of modern banking is not very old. An in-depth study of history of commercial banking in Western world dates back to two and a quarter centuries in the industrialized countries, which can be synchronized with the industrialization of the developed countries. In consonance with the growth of traders, manufactures, Industrialists, and other entrepreneurs, the need for commercial banking arose to meet the financial requirements, which became the backbone of the modern industrial and financial system. An efficient and smooth functioning of the business organization is an outcome of the backing of the sound banking system. However, all this happened against the backdrop of western cultural traditions, which has shrugged off the moral and ethical considerations of Christianity from economic and business traditions in its early stages of development. At the advent of development strategies of Muslim communities towards industrializing their economies on the pattern of capitalism, the need for commercial banking system was felt. The Muslims had to choose one out of the following options:

1. To accept the prevalent system of banking based on the concept of interest (riba) and provide the justification that interest does not contain the element of riba. Therefore, the modern banking system should be made permissible and the interest rate should be allowed to prevail and made *halal*, so that the Muslim may not have any reservation about it.

2. To reject the first option on the ground that the western system of banking is full of injustice to the borrower and the interest has element of riba. Therefore, it becomes indispensable to evolve the alternative system of banking which is free from interest. This will also not violate any tenets of Islam.

Therefore, in the light of above statement, the concept of Islamic Banking was pursued as an alternative approach to conventional banking, which came into intense discussion just three decades ago from now. The modern banking system came under heavy attack of Muslim jurists as interest as reward for parting with liquidity was assumed *haram* as per the principles of Islam. Prior to this, Islamic banking failed to attract the attention of both bankers as well as academicians on pragmatic grounds. As it was evincive from the fact that interest free banking system was not prevalent in any part of the world, as it became the most stumbling block on those who wanted to evolve Islamic Banking, therefore, they failed to convince the skeptics. It is quite imperative to quote the experience of an early effort of Prof. A.I Qureshi, which he incorporated in his book "Islam and Theory of Interest" published in 1986 wherein he quoted the criticism laid against Islamic banking by Findlay Shiras in the Annual Meeting of Indian Economic Association in the early forties as a manifestation of "religious zeal of a Muslim."

Concept of Riba in the Great Scriptures:

The *Aqeedah* (belief system) of Islam is believed to be exactly the same in every single one of the four scriptures and several scrolls and is thought exactly the same by every Prophet. Considering this, it can be assumed that the theological aspects of the Zabur would be exactly the same as in the Qur'an. But it got jolted due to major alterations done by those who have vested interests in distorting the basic tenets of Islam to create convenient corridors to usher in the self generated rules to benefit the capitalist class. Principles of Islam was spread on this esarth by Allah through revelations of holy books zabur, torah and Injeel but their preaching could not make real dent on the life of human being, The Zabur of Dawud (David –Peace be upon him) is referred to in the Qur'an as one of God's books revealed to four selected messengers. The Zabur is preceded by the Taurat (Torah) given to Moses (peace be upon him) and followed by the Injeel (Gospel) given to Jesus (peace be upon him) and finally the Qur'an given to the Prophet Muhammad (peace be upon him). But the revelation of Allah' Qur'an message on Islamic laws by Prophet Muhammad (peace be upon him) created the complete religion so that Qur'an became the last God's book on Islam. It is also claimed by the Muslims that Qur'an was not maneuvered at all by anyone. The Sharia or laws of Islam founded by earlier Prophets, however, are known to have changed slightly depending on the Prophets of the time, although the Sharia that is revealed in the Qur'an is final till the end of time as there will be no Prophet after Muhammad, and no book after the Qur'an. Hence the laws of the Zabur (in the present form) need not be exactly the same as what is Islam of today (as in the Sharia of the Qur'an).

According to Jewish tradition the Torah was revealed to Moses in 1312 BCE at Mount Sinai; Outside of its central significance in Judaism, the *Torah* is accepted by Christianity as part of the Bible, comprising the first five books of the Old Testament. It is also accepted by Muslims as the Divine book, although they think it is modified after the death of Moses.

Therefore, Muslims without any exception believe that the other original gospels have undergone many changes, or *tahrif*, over time. Some Muslims argue that the current Christian gospels might contain fragments of Jesus' (peace be upon him) original message, yet still hold that the majority of the original teachings have been corrupted and that is impossible to recover.

The word Injil appears twelve times in the Qur'an and refers to the revelation given to Jesus, prohibiting Riba. It is prohibited because "Riba has seventy segments, least being equivalent to a man committing

adultery with his mother" a tradition of the Prophet Muhammad narrated by Abu Hurairah (Haron and Shanmugan, 1997, p. 55)

Qur'an disapproves both paying and receiving interest. The Arabic version of interest in the Qur'an is riba which has been condemned in the strongest terms possible. Riba is translated as usury but its literal meaning is an excess, addition or growth. Islamic jurists have classified usury into two types:

Type 1 usury: This type of usury of debt was prevalent amongst Arabs during the early days of Islam. This was also known as usury of delay or usury of waiting (riba al-nasia). This type of riba may arise in two different situations, first as an excess over and above the amount of the principal. The repayment of which is incorporated as an obligatory condition of the giving of a loan. In the second situation, an excess amount is imposed over and above the amount of the principal if the borrower fails to repay the principal on the due date. Thus, the borrower may extend the date of payment against the extra amount. But if the payment is not made on this extended date also, the borrower will have to pay double of the excess amount paid earlier. This practice of charging excess amount will have detrimental effect on the sustenance of the borrower.

Type 2 usury: The usury of trade (riba al-buyu') is another category of charging/paying riba, prevalent in the early days in Arab, which is also known as riba al-adl. It relates to buying and selling of a commodity in exchange of the same commodity. But this practice was prohibited by Prophet Muhammad (peace be upon him). To strengthen, the prohibition of riba, the tradition of the Prophet (peace be upon him) can be cited as evidence. In this regard, Abu Sa'd al-Khudri said:

"The prophet (peace be upon him) said: Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, hand to hand. Whosoever pays more or takes more has indulged in riba. The taker and giver are alike [guilt]". The opinion on which, Islamic banking is based, reflects the convergence of the ideas of Islamic jurisprudence and stated in the following lines: " (Riba)

is identical with the excess stipulated as an obligatory condition in the contract, which is one of the two types of usury prohibited by the Islamic *Sharia*". Both types of usury are prohibited by the Islamic Sharia', even second type of usury admits the possibility of fraud in transactions.

This view is based on the concept that there should not be any element of uncertainty (Gharar) in any contract, in which the parties have entered. The element of uncertainty should be absent in the real transaction of financial products as well as trading of the commodities. Islamic Fiqh Academy established by the organization of Islamic Conference (OIC) in its Second Session held at Jeddah, Saudi Arabia in the year 1985 declared that "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 forms of usury (riba), which is prohibited under the Sharia'".

Theoretical Constructs of Islamic Banking:

Islamic banking has been defined variously by plethora of Islamic economists but complete vacuum can be seen in these definitions. Therefore, the Islamic banking can be defined as that form of modern banking (interest free) which is based on basic tenets of Islam developed in the first centuries of Islam, using risk-sharing as its main method, and excluding financing based on a fixed, pre-determined return.

Islamic bank can be distinguished from non-Islamic banks on the ground that Islamic laws constitute the backbone of all the Islamic banks and moral principles and Sharia' play pivotal role in the operation of these banks. Second important point that creates difference between these two types of banks could be the products and services offered without interest being accrued on it. These products are based on risk

sharing agreements. Third principle must conforms to the organizational structure and corporate governance monitored by the Islamic Board that ensures that bank's practices are in line with the contents of Sharia and a strong social solidarity division. All these characteristics of Islamic banks promote the establishment of investment banks, commercial banks and development banks.

To understand the Islamic banking, principles of Islamic economics need to be analyzed in all senses.

Principles of Islamic Economics:

The principles of economics that we all know so far is free from value judgements and is of positive nature whereas the Islamic economics is more of normative nature because it is prescriptive and is based on certain do's and don'ts. There are seven economic principles on which entire Islamic banking is based:

1. Justice, equality and solidarity: These three principles of Islam are the main pillars of Islamic banking. All businesses should be conducted keeping in view the fact that business should not promote monopolization or undue advantage should not be derived from an inexperienced partner. Solidarity can be encouraged by promoting alms giving as a noble deed which fructifies by paying *Zakat*, a tax on wealth, usually 2.5% of personal wealth.
2. Forbidden objects and creatures: Islam forbids those objects which are unclean and unhygienic like, pigs and also fortune telling books based on astrology. Therefore, such objects cannot form part of legal transactions. Certain objects are clean but not tradable, such as the soil of holy places. The numbers of prohibitions are extensive and unsystematic.
3. Acquisition of property rights: Islam postulates three methods of acquiring property.

   A) New rights can only be created when labour is exerted on natural resources.

   B) Old rights can be transferred by exchanging counter value of the same worth.

   C) Old rights can also be transferred through voluntary gift or inheritances.

   Property acquired through interest cannot form legal form of property because it is not acquired in one of the three legal ways. Thus, Islam does not permit payment of interest for a counter value of the same worth, nor given voluntarily.
4. Rational and Fair Use of Property (wealth): Islam rejects unproductive hoarding and wasting of money. Since the wealth is bestowed on us by God and it should be treated as means to end but not an end in itself. It should be spent in a responsible way in the light of teachings of Islam. The rights of property as given in Islam should not be used contrary to the interest of the community.
5. Gain without effort is forbidden in Islam: According to Sachacht (1964, p. 145), "receiving a monetary advantage without giving a counter value" is forbidden in Islam. Profit and financial gain is totally permitted so long as an effort is performed honestly and the liability of profit or loss of venture is accepted. The venture should be productive and should increase the value which will result in increase in value and profit. On the whole, entire business activity should be performed on the sound ground of Sharia.
6. Creditors-debtors relationship: Islamic viewpoint states that the debtors in financial distress should be dealt with leniently. In the event of debtors' inability to repay the loan in time, sufficient time should be allowed to the borrower to repay the loan. If possible, the debtor should be made free not to make the payment to ease his financial viability.

7. Duality of risk: Islam believes in the duality of risk. According to Islamic mythology, the investor has to make trade-off between risk and no risk. On the one hand, Islam promotes the partial acceptability of liability in a productive venture as a legitimization of share in profit. On the other hand, risk should be taken cautiously. Excessive and uncontrollable risk/obligation should be avoided. For example, sale of an object which the seller himself does not possess is treated to be illegal. The activities relating to gambling and speculation are forbidden because of excessive uncertainty. Finally, uncertainty in the obligations of contracting parties is forbidden. The object of a contract must be known, ascertained and in the existence.

Review of Literature:

Various early writings on the lines of Islamic banking converges to the re-organization of banking based on profit/loss sharing basis rather than the interest free banking. Therefore, the interest free banking is of recent origin. Anwar Qureshi (1946), Naeim Siddiqi (1948) and Mahmud Ahmed (1952) expounded the concept of the modern banking based on profit/loss sharing basis (Mudarabha). This concept got further exposition by the work of Mawdudi in 1950 and the contribution of Muhammad Hamidullah in 1944, 1955, 1957 and 1962. The scholarly writings recognized the need for the commercial banks which is free from the evil of interest rather it would be on the lines of Mudarabha as enshrined in Islam. Based on these principles, interest free banking became the corner-stone in the thinking of the many economists both in Pakistan and other Muslim dominated countries. The literature on Islamic banking available so far suggest that Muhammad Uzair (1955) became first author on interest free banking, followed by works emerging in the late sixties and early seventies. In this respect, Abdullah al-Araby (1967), Nejatullah Siddiqi (1961, 69), Al- najjar (1971) and Baqir al- Sadr (1961, 1974) were perhaps the largest contributor in this area.

The development of Islamic thinking on institutional lines can also be seen from the first Conference of the Finance Ministers of the Islamic countries held at Karachi in 1970, followed by the Egyptian study in 1972, and the First International Conference on Islamic Economics in Mecca in 1976 and the International Conference in London in 1977. The chronology of conferences relating to the evolvement of concepts and possibilities of interest free banking and their impact on the rest of the economy and the world can be judged as testimony of creating worldwide interest in the subject.

These conferences are: conference on "Islamic Banking: Its impact on World Financial and Commercial Practices" held in London in 1984, Workshop on Industrial Financing Activities of Islamic Banks held in Vienna in 1986, International Conference on Islamic Banking and Finance: Current Issues and Future Prospects held in Washington, DC in 1986, Islamic Banking Conference held in Geneva in 1986 and Conference 'Into the 1990's with Islamic Banking held in London in 1988. The most recent one is the Workshop on the Elimination of Riba from the economy held in Islamabad in 1992.

The involvement of institutions and governments led to the applications of theory to practice and outcome was the birth of interest free banks. The Islamic Development Bank, an inter-governmental bank established in 1975 was the brain child of this process.

Growth of Interest Free Bank:

As a result of lot of exercises done for application of Islamic theory on the practice of Islamic banking, a first private interest free bank, Dubai Islamic Bank came into existence in 1975 by a group of Muslim businessmen both from Dubai and other countries. The chain of private interest free banks can be seen from the establishment of Bahrain Islamic Bank, Faisal Islamic Bank (1977) both in Egypt and in Sudan. Kuwaiti government also established Kuwait Finance House.

Malaysia and Pakistan established one each bank in the mid-forties and late fifties respectively but none survived. In another effort in 1962, the Malaysian government founded "Pilgrim's Management Fund" to create fund and provide profit on their saving. Egypt also established saving bank at Mit-Ghamr which became very popular but was closed for a number of reasons. In another effort in Egypt, Nasser Social Bank was created in 1972 to meet the objectives of Islamic Banking, but it is more of social than commercial.

Presently, more than one hundred Islamic Banks and financial institutions are found in practical existence spread throughout the world, both in Muslim and non-Muslim dominated countries. In non-Muslim dominated countries, interest free banks were confined largely in Western Europe like., Denmark, Luxembourg, Switzerland and the U.K. Substantial growth in the establishment of Bank can be seen in 1983 (11) and in 1984 (13), followed by considerable rise in their number in the future.

According to the reports of International Association of Islamic Banks (IAIB), the number of financial institutions registered with it has recorded to the level of 166 but the complete data is available regarding only 100 banks with 8000 branches, employing nearly 45000 persons. The total deposits of these Islamic banks have also exceeded US $ 43 billion with total assets of US $ 54 billion. The capital of Islamic banks went up to the level of US $ 2.5 billion. The figures contained herein exclude the deposits and capitals of all the commercial banks of Pakistan, Sudan and Indonesia. Wall Street Journal of 1996 reported that in the next 10 years from now, more than 50% saving of the Islamic world will be handled by the Islamic banks alone.

It was found that most interest free banks were brought into being by the private initiative in Iran and Pakistan which transformed all banks to function on profit and loss sharing basis (PLS). In Pakistan, no banks were allowed to pay interest on deposits effective from 1st July 1985; instead all existing deposits became subject to PLS rules. In Iran, some administrative steps were taken with effect from February 1981 to eradicate interest from banking operations. Interest on all assets was replaced by a 4% maximum service charge and by 4% to 8% profit rate depending on the type of economic activity. Interest on deposits was also converted into a guaranteed minimum profit. Iran also invoked the Usury Free banking Law in 1983 to convert the whole system of banking into interest free till March, 1985.

In order to understand the functioning of Islamic banking pragmatically, it is imperative to describe the following two broad activities of these banks. One is, how these banks handle the fund i.e., how it operates various accounts and the other is, how it meets the requirements of the business by offering financial assistance. This has been done in the second part of this paper.

Management of Funds under Islamic Banking System:

Islamic Bank, like other banks, attracts financial resources from individuals and institutions and directs them towards business firms to meet the need of external finance to support their production activities. Thus, Islamic banks perform the same functions of financial intermediation as is performed by the traditional banks. Though, there exists basic difference between Islamic banks and interest based banks. The difference can be seen in how these functions are performed i.e., how they raise financial funds and how they use them. The entire banking system revolves around sources by which they get fund and the channels in which they invest their funds.

Sources of Funds:

A) **Current Accounts:** Like the conventional banking, Islamic banks also provide the facility of current accounts to their customers. These accounts are in the nature of demand deposits, for which the customers need not to give advance notice to withdraw money, as the banks are allowed to use money with full guarantee to return on demand. Since the bank bears all the risks, therefore, the depositors are not entitled to any share in profit earned by the bank.

B) Saving Accounts: These banks also offer saving accounts in four sub-variants.

(i) In this type of accounts, the depositors have to submit his consent on the deposited amount in saving bank accounts to use the fund at the banker's risk. The banker can share some profit with the depositors at its own discretion. Return of deposit is fully guaranteed. Al-Wadi'a (Trust)

(ii) On this type of deposits, an authorization to invest is obtained and the profit is shared as per agreed terms for which required minimum balance is maintained.

(iii) Saving deposits of this nature, enables the customers to get both pecuniary and non-pecuniary benefits. Qard Hasan (A benevolent loan)

(iv) Saving deposits are treated as a part of investment pool. In this type of account, the depositors are given the right to withdraw money without notice for which the depositors are not entitled to get share in profit for the period in which the withdrawal is done.

C) Investment Accounts: Investment deposits in Islamic banking are counterpart of 'term deposits' in the traditional banking system. They are popularly known as Profit-and-loss Sharing (PLS) or participatory accounts. Such type of accounts may be operated by individuals as well as companies for whom no interest is rewarded to the depositors. Instead the depositors are entitled to get a share in an agreed proportion of profit accruing to the bank. This is calculated on the basis of amounts deposited and the period for which the deposits are retained by the bank. The accounting practices as prevalent in most countries suggest multiplying the amount held, by the period for which such amount has been retained by the bank. Thus, the profits are distributed on pro-rata basis. Bankers ordinarily do not allow withdrawal from investment account. But if it does so, no profit is paid on such amount.

D) Joint or General Investment Accounts: It has become prevalent practice in some Islamic banks to create investment pool in lieu of fixed/term deposits. In this system, deposits are pooled to form general investment account, deposits having different maturity periods. The funds are not utilized for specific projects instead they are utilized for financing different projects. The profits accruing from such projects are accounted for and distributed on pro-rata basis.

E) Limited Period Investment Deposits Accounts: This is also prevailing practices in some Islamic banks to obtain fund/deposits for certain specified time period based on the mutual consent of both the banker and the depositor. The contract so made gets terminated at the end of the period but the profits are distributed at the end of the financial year.

F) Unlimited Period Investment Deposits Accounts: The investment deposits are automatically renewable without specifying the period. The plan can be terminated on the receipt of notice of termination; usually three months notice is required. In this type of investment deposits, neither withdrawal nor addition in the amount is permitted during this period. Profits are calculated and distributed at the end of the financial year.

G) Specified Investment Deposits Accounts: Some Islamic banks have developed the practice of accepting deposits linked to specific projects as authorized by the depositors to invest. Profits are distributed between the banker and the depositor or the banker may charge certain fee for such services. This becomes agency function of the bank.

Uses of Funds:

The raison d'être of Islamic banking is the prohibition of interest (Riba). The consideration of interest is focal point on which the entire banking system of the present time is based. The manifestation of the

creditor-debtor relationship between the depositor and the bank on the one hand and between the borrower and the bank on the other hand assumes the corner stone in the history of banking. Interest has been viewed as the price for using money. The provisions relating to lending of money (qard) is that it should be given or taken free of cost so that the contingency requirements of the borrower can be met. The creditor should not take undue advantage of being creditor. As against it, in the modern banking system, money is lent on the basis of interest, more often than not; it ends up in some kind of injustice to the borrowing party. Islamic principle in these kinds of transactions is that "deal not unjustly and ye shall not be dealt with unjustly" (al Quran, 2:279). Hence, commercial banking in an Islamic framework could not be based on the creditor-debtor relationship. Islam justifies interest free banking as well as other financial transactions, as there is no profit without risk and responsibility. This principle underlies the famous juristic axiom al Ghumn bi al Ghurm. Thus, profit and responsibility are the result of ownership. Hence, the capital has to be exposed to business risks if it has to bring some return. Any financial intermediation shall take place using these principles as contained in Islam.

Financing techniques used by Islamic banks may be summarized as follows.

- **Murabaha (Mark-up or Cost-plus based financing):** Most of the Islamic banks have adopted this technique of financing. It has also been estimated that nearly 80% to 90% of the financial operations are performed by the banks under this method.
- **Working of Murabaha**: Under this system, the banker collects the information regarding the price, nature, specification, name of dealers, transport cost, custom duty etc. to facilitate loan to the clients. The banker can bestow faith in the client itself to collect information. The banker clarifies the cost of the product separately from the margin that the banker is going to charge. If the client accepts the condition of the banker, a deal of contract is signed between the banker and the client, the signed contract is known as Murabaha. Thereafter, the commodity is purchased by the banker by paying cash and the commodity is handed over to the client. The execution of the sale deed is between the banker and the seller of the commodity. Therefore, the commodity is registered in the name of the banker. The banker now possess right to sell to the actual client through deferred payment basis at an agreed price. This price includes the actual price that the banker has paid to the dealer plus the mark up that the banker is going to charge. The client repays the debt to the banker either through installment or in lump sum at a later date. The new price may include the cost of transportation, cost of handling, transportation cost, custom duty or even sales tax. However, the bank will disclose the amount involved along with other costs.
- **Conditions to be valid for successful culmination of Murabaha**: The profit margin or mark-up that bank is charging must be mutually determined between the banker and the client. The cost of the product that the banker initially pays plus the margin of the bank should be clearly and separately communicated to the client.

  The goods in question should be in the physical possession of the banker before it is sold to the client. This need to be clarified that the transaction between the banker and the seller should be kept separate from the transaction between the banker and the client.

  To be crystal clear in all dealings, most of the Islamic banks prefer to affect Murabaha deal in two different stages, by using two different forms. The first form that is used between the client and the banker is a promise made by the client to purchase the commodity with the help of the banker. It should be made clear that promise is just promise, not enforceable in the court of Islamic law. Hence, the client can alter his decision to buy the commodity and the risk of loss is absolutely borne by the banker in all senses. The second form that is used regarding the final

deal between the banker and the client takes place at the time of delivery of goods. In this form, all the terms and conditions are clearly mentioned concerning to the deferred payment and the payment of the sum in various installments.

The Murabaha deal has become the most popular method of financing in many countries of the world. It is being used to satisfy the financing need of the diverse sectors of the economy, ranging from consumer durables like; cars, house and household appliances. It is being used in the production sector also, like; financing the purchase of machinery, equipment and raw materials. In fact, Murabaha is highly popular in the area of financing the short term trade in which it has gained real success.

Ijarah (Leasing)

It is an alternative form of financing technique used by the Islamic banking. In this type of leasing, the bank retains with itself the ownership right on the asset and leases it to the client. Bank may purchase the asset as per the client as it was the case in Murabaha. The period of lease may vary from three months to five year determined mutually depending upon the value of asset, despite the fact that there is no provision in Islamic law regarding the period of lease. During the period of lease, the ownership of the asset remains with the banker, though, the physical possession of the asset remains with the client for its use. After the expiry of the lease, the commodity is reverting back to the original owner of the asset. Another variant of leasing is the lease purchase agreement in which the lessee has the option to purchase the asset at the expiry of the lease period at an agreed price. It has also been seen that rental installments have been clubbed in the price of the asset by the mutual agreement of the parties concerned.

- **Musharakah (Partnership):** In this type of Islamic financing, project is financed by two or more than two financiers. Profits are shared in accordance with agreed ratio but the losses are to be appropriated in the ratio of capital contribution by each party (bank). The participants can either participate in the management or delegate someone else for this task. Musharakah can be of two types.

- **Permanent Musharakah/Diminishing Musharakah:** The permanent Musharakah enables the bank to participate in equity and receives an annual share of profit on a pro-rata basis. In this type of financing, the time limit is unspecified for the termination of contract; therefore, the participants can take part so long as the parties concerned feels to continue. On the contrary, the diminishing Musharakah allows equity participation in the first place and share in profit on a pro-rata basis. In this way, equity held by the bank keeps on diminishing progressively overtime. At the end, the equity held by the bank shall reach zero level and it shall no longer remain a partner. This technique of financing is getting more popularity being offered by the Islamic banks.

- **Mudarabha (Profit Sharing):** The Islamic banking model is based upon the principle of profit sharing and is referred in Islamic jurisprudence as mudarabah. The Muslim economists have explored that entire commercial banking in an Islamic context could be organized on the basis of two tier mudarabah.

- **First Tier of Mudarabaha:** Such agreement can be envisaged between the bank and the depositor who has laid down his savings in his bank investment account to get share in profit. Under this system, the bank is authorized to invest the money in any profitable venture it finds worth. In this case the depositor is the provider of capital (Rabb al Mal) and the bank functions as Manager (Mudarib).

- **The second Tier of Mudarabaha:** This agreement is between the bank and the entrepreneur who seeks finance from the bank on the condition that profits accruing from business shall be shared between the banker and the entrepreneur in a previously agreed proportion but the loss will be borne by the financier only. In such cases, the banker acts a provider of capital whereas the entrepreneur acts as a manager. In case there is more than one financier of the project, the profit shall be shared on mutually agreed proportion but the loss shall be shared in the proportion in which the different financiers have contributed the capital.

  The basic principle of the Mudarabaha as a basis of financial intermediation in the Islamic economy is offered as a viable alternative to interest based banking system. As the creditor does not earn any interest on a fixed rate in this system but earns profit by participating in the business risk. Thus, the cost of capital is not zero as some people presume that Islamic banking system is analogous to a system of banking based on zero interest rate. Actually, the Islamic banking is different from conventional banking in the sense that the cost of capital in interest rate based banking system is expressed in the form of a pre-determined fixed rate while in the Islamic banking; it is neither fixed nor pre-determined.

Mudarabha can be of two types:

Joint mudarabha/Individual mudarabha: The joint mudarabha may be possible between the investors and the banks on a continuous basis. To do so, the investors keep their money in a special fund, which is operated by the bank in continuous joint financing. The investors receive proportionate share of the net profit realized even without the liquidation of those financing operations which have not reached the stage of final settlement. But the individual mudarabha takes place when the bank provides finance to a commercial venture run by an individual or by a company on the basis of profit sharing basis.

According to some Islamic theorists who have postulated mudarabha, this scheme of financing should be a dominant mode of financing under Islamic banking. This technique has failed to make a head way due to its various conceptual, practical and legal hindrances. Mudarabha has been practiced by Jordan Islamic Bank.

- **Loans with a Service Charge:** The organization of the Islamic Conference, instituted by the Council of the Islamic Fiqh Academy, in its third session held at Amman resolved that banks are permitted to charge a fee for loan related services; however, this fee should not exceed the actual expenses. But if the fee charges exceed the actual expenses, it may be considered as usurious and must be forbidden by Islam. Since, then the Islamic bank provides loan against service charge. It was also ruled that the service charge can be claimed only at the end of the period because the actual expenses can be known at the end only. In the intermittent period, the client may be charged some approximate service charge. The banker can reimburse or re-claim the difference only at the end of the period when actual expense will be known.

- **Qard Hasan (Interest free loan):** It has been learnt that most Islamic banks provide loan which is free from interest. However, the practice of providing interest free loan by different Islamic banks differs in respect of the following nomenclature. Some bank provide the privilege of interest free loan to only those who have investment account at the bank; Other banks provide loans even to needy students and other weaker sections of the society;

  The last category of recipient of loan by bank could be small producers, farmers, and entrepreneurs who are not qualified to receive financing from other sources. The interest free loan is aimed to ameliorate them from the clutches of dependency in making them independent or to raise their

incomes and standard of living. In Pakistan, banks draw distinction between ordinary loans which is with some service charge and quard hasan loan which is free from any service charge.

Conclusions:

The basic difference between a capitalist and Islamic economy is that in secular capitalism, the profit motive or private ownership are given unbridled power to make economic decisions. Their liberty is not controlled by any divine injunctions. The evils emanating from this attitude can never be curbed unless humanity submits to divine authority and obeys its commandments in any case and at every price. This is exactly what Islam does. Assuming that banks consider the onus of private ownership, a profit motive and market force, Islam has put certain divine restrictions on economic activities. These restrictions being imposed by Allah Almighty, Whose knowledge is abound, cannot be removed by any human authority. All these prohibitions combined together have a cumulative effect of maintaining balance, distributive justice and equality of opportunity.

The Islamic banking system, which has emerged during the past few decades, is still in its early stages of development. It has succeeded in establishing the feasibility of banking on a basis other than the interest rate. Even the western commercial banking system was not created instantaneously. It was evolved over a long period of time necessitating learning from past mistakes and continually improving banking and financing techniques. Similarly, the techniques of Islamic banking cannot be created in a short span of time. They will have to be evolved. The significance of an Islamic banking institution is that it aspires to perform the same functions as those of modern commercial banks without indulging in Riba. To this extent, Islamic banks provide an alternative to interest based banking for religious reasons. If there are certain other economic advantages accruing from their functioning on a basis other than interest, they only add to the usefulness of Islamic banks as an alternate institution.

Similarly, nothing forbids Islamic banks to carry out, in addition to their normal banking functions, other functions, which would contribute towards establishing the Islamic order and propagating the most cherished Islamic values in the field of economic and business activities. But it would be presumptuous to think that the mere establishment of a few Islamic banks would automatically lead, through market forces or otherwise, to the establishment of an Islamic economy. However, it has a long way to go.

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