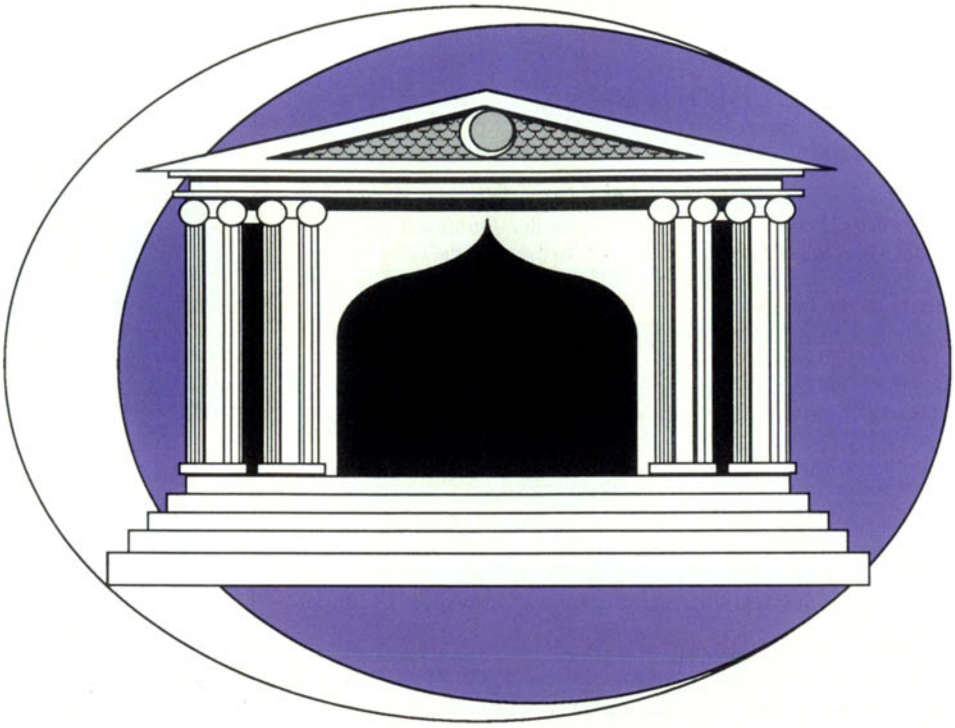

The framework and practice of Islamic banking

The principal features of an Islamic economic system, and how financial institutions would operate within it

Mohsin S. Khan and Abbas Mirakhor

The resurgence of fundamental Islamic values in many parts of the world has manifested itself on the economic front as well, with a number of Muslim countries moving toward the transformation of their economic systems—especially the banking systems—to conform more closely with the precepts of Islam. Developments in the Islamic Republic of Iran and Pakistan have been particularly intensive and have attracted wide interest, both in other Muslim countries and elsewhere.

The popular conception of the Islamic economic and financial system is that it differs from other systems only in that it proscribes interest. Since the elimination of interest has generally been the first step in the Islamization of the economy, it is perhaps only natural that the institution of interest-free banking has received the most attention. While the abolition of interest-based transactions is a central tenet of the Islamic economic system, it is by no means an adequate description of the system as a whole.

Broadly speaking, "Islamic economics" defines a complete system that prescribes specific patterns of economic behavior for all individuals and society within an Islamic way of life. This article briefly describes the main characteristics of the Islamic economic system, shows how a financial system that fits into the framework of that system is likely to function, and describes some attempts at its implementation.

Islamic economic system

At the core of the Islamic economic system lies a collection of immutable and universal rules that affect economic behavior and relationships. These rules are specified by the *Shariah*, namely, the codification of injunctions given in the Quran, and the traditions of the Prophet Mohammed. On the periphery there are also rules and institutions which affect economic behavior, but which are subject to change depending on circumstances. Economic policy, designed by legitimate authorities, may vary from one Muslim society to another only with respect to the periphery of the system. Such policies must, nevertheless, be compatible with the *Shariah*.

Some of the key elements of the core of the Islamic economic system are the following:

- *Individual rights.* In Islam individual rights are a consequence of human obligations and not an antecedent to them. When these obligations are fulfilled, certain rights are gained. Islam stresses the need to respect the obligations as well as the rights of individuals; among them is first the duty, and then the right, of the individual to pursue his

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economic interests, within the framework of the *Shariah*.

• *Property rights.* Property rights in Islam are the result of three basic principles. The first asserts that God is the ultimate owner of all property; for man to become materially able to perform his duties, he has been given the right of possession as a trust. Second, property is only a means of achieving higher objectives and not an end in itself, and all members of the society share the natural resources at man's disposal. The third principle, called the principle of invariance of ownership, is derived from the first two. This establishes the rights of society and of other individuals in the final product. These rights are protected by the *Shariah* through the limitations imposed on the disposition of property and the wealth resulting from it.

• *Contracts.* Islam places all economic relations, including exchange, on the firm footing of contracts. The freedom to enter into contracts, designed within the framework of the *Shariah*, and the obligation to remain faithful to their stipulation has been deeply emphasized in Islam.

• *Prohibition of interest.* The Quran forcefully prohibits the payment and receipt of interest, or *riba*. Strictly speaking, the term *riba* refers to the addition to the amount of principal of a loan on the basis of time for which it is loaned, or of the time for which the payment is deferred. In accordance with Islamic jurisprudence it signifies the additional money charged in a money-money type exchange or the uncompensated increase in a commodity-commodity transaction. There is now a consensus of opinion among Muslim scholars that this prohibition extends to any and all forms of interest.

• *Work and wealth.* Islam exalts work and considers it as an inseparable dimension of faith itself. Conversely, idleness is viewed as a manifestation of unbelief in the religion. All persons are exhorted to work in order to earn their living, and no one who is physically and mentally able is allowed to become a liability to his family or the state through idleness and voluntary unemployment.

Wealth itself is considered as an important means by which man can pave the way for the attainment of his ultimate objective. It is considered among the highest blessings bestowed on man and everyone is encouraged to strive for it. However, the methods of earning, possession, and disposition are defined by the *Shariah*. Among these rules are those relating to extravagance in consumption, waste, the obligation of sharing (through mandatory levies); and those on inheritance. These rules are aimed at modifying patterns of income and wealth distribution.

•*Role of the state.* The state's role in the Islamic economy relates to ensuring, first, that everyone has equal access to natural resources and means of livelihood; second, that each individual has equal opportunity, including education, skills, and technology, to use these resources; third, that markets are supervised to ensure justice in exchange (Islam places great emphasis on the market and its efficient operation, and the *Shariah* has provided a network of ethical and moral rules of behavior which cover all market participants); fourth, that transfer takes place from those more able to use the economy's resources to those less able, according to the rules of the *Shariah*; and, finally, that distributive justice is assured for the next generation through the implementation of the laws of inheritance.

The state is empowered, within the framework of the *Shariah*, to design any specific economic policy that is required in order to guarantee the attainment of these objectives and to meet the necessary expenditure associated with the performance of its duties through taxation and utilization of national resources.

Islamic banking

Islamic banking, clearly, is intended to operate within an economic system some of whose features have been briefly described above. The principal restriction under which the financial system must work is the injunction against interest. However, what is forbidden is the fixed or predetermined return on financial transactions and not an uncertain rate of return, represented, for example, by profits.

Prohibition of interest. Although the fact of prohibition against interest in Islamic banking is axiomatic, a variety of arguments have been provided by Islamic scholars to explain and justify its application. One argument which has not received any attention in the literature on Islamic banking, and which goes a long way in justifying the prohibition, is based on Islam's position on property rights and obligations and its conception of economic justice.

Money represents the monetized claim of its owner to property rights created by assets that were obtained through work or transfer. Lending money, in effect, is a transfer of this right and all that can be claimed in return is its equivalent and no more. Thus, interest on money is considered as representing unjustified creation of instantaneous property rights: unjustified, because interest is property right claimed outside the legitimate framework of recognized property rights; instantaneous, because as soon as the contract for lending upon interest is concluded, a right to the borrower's property is created for the lender. On the other hand, when the financial capital of the lender is used in partnership with the human capital and labor of the entrepreneur, the lender's right to his property is not transferred and he shares, as co-owner, the final product his money has helped to create. He will be remunerated in proportion to his financial investment in the ensuing incremental wealth. This emphasis on profit-sharing provides the basis for the development of an Islamic financial system.

In broad terms, the transformation of banking from an interest-based system to one that relies on profit- and loss-sharing makes an Islamic banking system essentially an equity-based system. In such a system depositors are treated as if they were the shareholders of the bank, and consequently are not guaranteed a nominal value, or a predetermined rate of return, on their deposits. If the bank makes a profit, the shareholder (depositor) is entitled to receive a certain share of it; on the other hand, if the bank incurs a loss, the depositor is expected to share in it and thus receive a negative rate of return. From the depositors' perspective, then, an Islamic bank is in most respects identical to a mutual fund or an investment trust. Furthermore, to remain consistent with religious strictures, banks cannot charge interest on their lending operations, but have to use special modes of investment and financing that are also based on profit and loss sharing.

Sources of funds. Besides its own capital and equity, the main sources of funds for Islamic banks would be two forms of deposits—transaction deposits and investment deposits.

Transaction deposits are directly related to transactions and payments, and can be regarded as equivalent to demand deposits in a conventional banking system. Although a bank would guarantee the nominal value of the deposit, it would pay no return on this type of liability. Generally speaking, funds mobilized through this source cannot be used for profitable investment by banks. As such, banks would presumably have to levy a service charge on deposit holders to cover the cost of administering this type of account.

Investment deposits constitute the principal source of funds for banks and they more closely resemble shares in a firm, rather than time and saving deposits of the customary sort. The bank offering investment deposits would provide no guarantee on their nominal value, and would not pay a fixed rate of return. Depositors, instead, would be treated as if they were shareholders and therefore entitled to a share of the profits or losses made by the bank. The only contractual agreement between the depositor and the bank is the proportion in which profits and losses are to be distributed. The profit- or loss-sharing ratio has to be agreed in advance

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of the transaction between the bank and the depositors, and cannot be altered during the life of the contract, except by mutual consent.

Lending operations of banks. Islamic banks also are required by the *Shariah* to apply the same principles of profit- and loss-sharing in their loan operations. The two methods that fully satisfy the requirements of the law on the lending side are *Mudarabah* and *Musharakah* arrangements.

Under *Mudarabah* arrangements surplus funds are made available by the owner to the entrepreneur to be invested in a productive economic activity in return for a predetermined share of the profits earned. Financial losses are borne exclusively by the lender. The borrower, as such, loses only the time and effort invested in the venture. This arrangement, therefore, effectively places human capital on par with financial capital.

A *Musharakah* transaction is one in which there is more than a single contributor of funds. All parties invest in varying proportions and the profits and losses are shared strictly in relation to their respective capital contributions. The essential difference between the two forms of financing is the number of parties involved in the transaction and, indeed, *Musharakah* financing corresponds closely to an equity market in which shares can be acquired by the public, banks, and even the central bank and the government. For example, firms desiring to raise funds for investment could use this mechanism and offer *Musharakah* certificates in the market. Such certificates would be, in effect, transferable corporate instruments secured by the assets of the company. Their price, and the implicit rate of return, would be determined by the market.

Other modes of financing. In cases where profit-loss sharing cannot be implemented, for example, in the case of small-scale borrowers or for consumption loans, a number of alternative instruments for investment and financing are available to banks. These include deferred payment sales or "mark-up," purchase with deferred delivery (known as *Bai' salam*), lease-purchase, beneficence loans, and the levying of a service charge.

Role of the central bank. Under an Islamic system, operations are undoubtedly more varied and complex than in a traditional banking system. In terms of profit-sharing activities, the criterion of creditworthiness of the borrower that underlies the conventional banking system has to be changed to place more emphasis on the viability and profitability of projects. In addition to a term structure of rates of return, there has to be a structure of returns from different economic activities that banks have to consider. Project evaluation and appraisal, determination of profit-sharing ratios, and the establishment of a procedural framework for the processing, monitoring, supervision, and auditing of various projects create new demands on commercial banks.

The monetary authorities operating in an Islamic framework continue to have the power to regulate banking and financial operations in the economy, both to allocate resources in conformity with the priorities of the society, and to direct monetary policy toward specific goals. To achieve its policy objectives, the central bank has control over the supply of "high-powered" money (that is currency plus deposit liabilities of the central bank to commercial banks), the reserve ratios on different types of liabilities, and the maximum amounts of assets that banks can allocate to their profit-sharing activities. A further control is available to the central bank through its purchases of equity shares of banks and other financial intermediaries. Through performance of its regulatory, supervisory, and control functions, as well as its lender-of-last-resort role, the central bank can continue to exert substantial influence on the financial system. Moreover, opportunities may exist for direct investing in the real sector on a profit-sharing basis, as well as taking equity positions in joint ventures along with other banks. The ability to buy and sell securities representing real assets in the financial market, that is, open market operations, would still be permitted as long as these securities do not have par value features and a nonzero coupon rate.

Additionally, the suggestion has been made that the central bank could regulate profit-sharing ratios between the banks and borrowers on the one hand, and the banks and depositors on the other. Variations in these ratios would alter the rates of return and could have the same impact as changes in interest rates on the overall and sectoral flows of financial resources.

Impact of monetary policy. The main accounting relationships that can be expected to exist in an Islamic financial system are summarized in the accompanying table.

In this stylized system the public's financial assets would be investment deposits, and its liabilities would be loans obtained under *Mudarabah* and *Musharakah* arrangements. The rates of return on both deposits and loans would be entirely market determined. The assets of commercial banks are credit extended to the public, and reserves held at the central bank. These reserves can be either legally imposed by the central bank or voluntary. The banking sector's liabilities are investment deposits and the equity of banks held by the central bank. The latter essentially represents the tool through which the central bank changes reserves, and thereby the flow of credit and rates of return, in the system.

In the literature, macroeconomic models that explicitly incorporate the flow of funds accounts presented in the table have been developed to show how an Islamic financial system would function and how it would interact with the real side of the economy. An analysis of such models indicates that there is apparently no fundamental change in the way monetary policy affects economic variables in an Islamic economy. The authorities can achieve the same results through controlling the supply of profit-based bank lending as they can through variations in the total money supply. While institutions and financial instruments may be quite different in an Islamic economy, the standard macroeconomic result, for example, that an expansionary monetary policy would reduce rates of return and increase output in the short run, carries through. What the authorities do lose in the process is the ability to set directly financial rates of return, a practice that is fairly common in developing countries; in this sense the financial system is more market-oriented in an Islamic economy.

Flow of funds accounts of the Islamic financial system

	Public		Banks		Central bank	
	Uses	Sources	Uses	Sources	Uses	Sources
Investment deposits	ΔD_p			ΔD_b		
Mudarabah credit		ΔF_p	ΔF_b			
Musharakah credit		ΔF_p^m	ΔF_b^m			
Equity of banks				ΔE_b	ΔE_c	
Reserves			ΔR_b			ΔR_c

Definition of symbols: D_p = public's investment deposits in the banking system, D_b = banks' deposit liabilities, F_p = public's *Mudarabah* liabilities to the banking system, F_b = banks' *Mudarabah* financing of investment projects, F_p^m = public's *Musharakah* liabilities to the banking system, F_b^m = banks' *Musharakah* financing of investment projects, E_b = banks' sale of equity shares to the central bank, E_c = central bank's purchase of equity shares in the banking system; R_b = banking system's reserves with the central bank, and R_c = central bank's holding of the reserves of the banking system.

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Practical applications

At present, about 45 countries, encompassing most of the Muslim world, have some form of Islamic banking or financial institution. Most of these have been established since the second half of the 1970s. This development has basically taken two forms. The first has been an attempt to establish Islamic financial institutions side by side with traditional banking. In such attempts, two types of institutions have evolved, Islamic commercial banks established mostly in Muslim countries, and Islamic investment and holding companies operating in some Muslim, but mostly in non-Muslim, countries. In both cases, generally, the banking operations of Islamic banks are subject to the specific regulations that apply to all banks. Examples of the first category are Faisal Islamic Banks in Egypt and Sudan, the Dubai Islamic Bank, and the Jordan Islamic Bank. Examples of the second—that is, investment holding companies having either a national or international mandate—include the Darul Mal Al-Islami (Geneva), the Islamic Investment Company (Bahamas), and the Bahrain Islamic Investment Bank. These institutions compete with conventional banks to attract deposits from Muslims who wish to avoid interest and invest these funds wherever they find profitable investment opportunities. The majority of these institutions were established through private initiatives.

The second form has involved an attempt to restructure the whole financial system of the economy to accord with Islamic precepts. This has taken two approaches, one in which the entire economy and its institutions, including financial, are transformed into an Islamic one, as in the Islamic Republic of Iran, and the other where total Islamization of the economy is undertaken through a gradual process beginning with the banking sector, as in Pakistan.

Pakistan

The process of Islamization of the banking system in Pakistan was initiated in 1979–80, when banks were allowed to accept deposits on a profit-loss sharing (PLS) basis. In June 1984 the Government announced a program for phased transformation of the entire financial system, including commercial and specialized banks as well as nonbank financial institutions, to non-interest-bearing Islamic financial modes during 1984–85. As of July 1, 1984, all financial institutions were allowed to carry out transactions on the basis of either Islamic or interest-based modes, on condition that interest-based accommodation for working capital would not be provided or renewed for more than six months. Effective January 1, 1985, all transactions with the Federal and Provincial Governments, public sector corporations, and public or private joint stock companies have been based on Islamic modes and, from April 1, 1985, all financing to all entities and individuals must be on an Islamic basis. The State Bank of Pakistan (the central bank) is empowered to determine for each permissible mode of Islamic financing the maximum and minimum rates of return to financial institutions. However, the specific instrument and the terms of any financial arrangements are to be agreed upon between the institution and its clients.

Even though a wide variety of banking modes is permitted, ranging from service fees to equity participation on the PLS basis, over 90 percent of bank lending has, up to now, been done on the basis of mark-up, mainly because of operational convenience. Mark-ups can vary according to the type of transaction or expected profit of the client, but within a range of 10–20 percent as prescribed by the State Bank of Pakistan. Depositors are assured of the security of their deposits and a share in the bank's earnings on the PLS basis.

The early experience of Pakistan has shown that the implementation of Islamic banking has not impaired the effectiveness of monetary policy. In fact, it is believed that the new system, by permitting variations in the range of mark-up rates as well as profit-sharing ratios, has enhanced the ability of the monetary authorities to affect allocation of financial resources. The effectiveness of the primary instrument of monetary policy, namely credit allocation, has remained unaffected. It is expected that through the gradual process of Islamization some significant changes will take place in the legal and institutional framework, which will enhance the transformation of the total system. Among these are: changes in the attitude of banks toward medium- and long-term lending on *Mudarabah* and *Musharakah* basis; comprehensive retraining of staff to enable them to evaluate and appraise investment projects; reform of the auditing and monitoring system; establishment of an efficient equity market and development of a secondary market; and the establishment of an efficient judicial arbitration system and legal framework to allow for settlement of disputes.

Islamic Republic of Iran

The most comprehensive implementation of the Islamic financial system to date has taken place in Iran. This is only natural in that the Islamic Revolution was meant to transform the total society. Because banking in Iran is an integral part of the much broader Islamic system, it should provide the most far reaching test of the effectiveness of Islamic banking within its natural framework of a total Islamic system.

Immediately following the Revolution steps were taken to transform the banking system by first nationalizing and then streamlining the system. The Bank Nationalization Act of 1979 reduced the number of banks from 36 to 9 and the total number of bank branches or offices were reduced by nearly 2,000. After this reorganization, interest was eliminated from banking operations and replaced by a service charge and minimum rates of profit, while the Law of Usury (Interest)-Free Banking was being developed for submission to the Parliament. The law was passed in late 1983 and implemented beginning March 21, 1984.

This law established 14 different modes of approved transactions and financing and 4 modes of transactions on the liability side. It required that all transactions be based on these specified modes of finance, that existing transactions be converted to the prescribed method within a year for deposits, and that all banking operations be carried out in accordance with the new law within three years after its enactment. While no returns are to be paid on current or saving deposits, the latter will be eligible for variable prizes and bonuses. The investment deposits can be utilized in two ways. The bank can either employ the funds on behalf of the depositor (as a trustee) to invest in profitable projects, in which case the depositor receives all the profits earned and the bank receives a commission; alternatively, the bank can use the depositor's funds along with its own resources and pay the depositor a predetermined portion of the profits earned.

The deposits of all banks were transformed into Islamic modes well before the legislated

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deadline. At present, the asset side of banks' balance sheets is being transformed into Islamic modes and it is expected that this transformation will be completed well before the legislated deadline. Because of a de-emphasis of collateral and creditworthiness of the borrower, and reliance on the viability and profitability of projects, the banks' clients, particularly in manufacturing, industrial, and agricultural sectors, have been encouraged to submit new investment projects for financing on a profit-sharing basis. A significant innovation by the banks has been their willingness to combine a variety of financing modes in order to provide the most financially advantageous package for their clients. The most serious difficulty faced by the banks has been the lack of trained and skilled staff (in the *Shariah* as well as banking) to appraise and monitor investment projects.

Problems of transition

A distinction has been made between the concept of Islamic banking implemented as a profit-making enterprise operating in an interest-based system and Islamic banking implemented as an integral part of a complete Islamic system. Each will face different sets of problems. In most of the Muslim world (and in some Western countries) Islamic banks compete with conventional banks. The problems faced by these banks will be of the type experienced by all attempts at transplanting parts of one system into another. Aside from problems of contradictions and conflict in basic values, these institutions will have to meet the challenges emanating from the legal and regulatory framework of the environments in which they wish to operate, as well as those generated by the requirements of security, viability, and profitability which conventional banking systems have tried to meet. In the meantime they will serve as a channel for mobilization of funds from interest-averting clients to profitable projects wherever they are found.

As for attempts of the second type, their success will depend on how intent these societies are in transforming their total system into an Islamic one in which not only the prerequisites of the Islamic economic system are implemented but also those of a successful and sound Islamic financial system are met. The provision of markets (in financial and real assets), which operate on the basis of the *Shariah*; the development of a legal framework which can implement the property rights structure of the Islamic system as well as Islamic laws of contracts; the necessary change of attitudes among the providers and users of surplus funds; and finally the provision of trained personnel for financial institutions seem to be the minimum requirements for operation of a banking system which will not only be sound but also meet the objectives and requirements of Islam.

In conclusion, policy makers in Islamic countries face a number of difficult problems as they move toward transforming their economies to be consistent with religious principles. There are many macroeconomic and financial issues that are as yet unresolved. These include, among others, the respective roles of monetary, fiscal, and exchange rate policies; the effects of changes in the system on financial intermediation, savings, and investment; and the impact of the change in financial institutions on growth and development. During the transition many seemingly ad hoc and second-best policies have needed to be adopted, but this is only natural as Islamization represents an attempt to apply Islamic rules and codes of economic behavior in countries in which economic and financial systems of largely foreign provenance have become well established. F&D

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