Chapter I
An Overview of Islamic Banking

1.1 History and Development

The emergence of interest-free financial institutions, especially in predominantly Muslim countries, has created a new dimension to economic models. Widely known as Islamic banks, these interest-free institutions are organised financial intermediaries which operate in accordance with Islamic Law (Shariah Law). Ahmad (1994) defines the term "Islamic banking" as the conduct of banking operations in consonance with Islamic teachings. The main principles of Islamic banking activities comprise of prohibition of interest in all forms of transaction, undertaking business and trade activities on the basis of fair and legitimate (halal) profit, giving zakat (alms tax), prohibition of monopoly, and cooperation for the benefit of society and development of all halal aspects of business that are not prohibited by Islam (Khan, 1983).

If we consider that the Islamic banking system is a banking system comprising of all modern banking products and services, it might lead us to conclude that this new concept of banking is a product of contemporary society. On the contrary, the existence of Islamic banking institutions and products can be traced back to the early days of Islam.¹

In the case of remittance activities, Islamic civilization also came to know this practice during the early days of Islam when there was evidence that money was transferred from one city to another without the movement of real cash. Money changers who had established offices in many locations initiated the usage of cheques in their money-transfer and other instruments of payment activities. Sayf al-Dawlah al-Hamdani (circa 350H/970) was the first recorded person in

¹ For example, Az Zubair bin Al Awwam (circa 620) was one of those who had been entrusted by the public as a keeper of their money and at one time the total deposited money amounted to 2,200,000 dirhams (Homoud, 1985).
Islamic banking history to issue a cheque for clearance between Baghdad and Aleppo (Homoud, 1994).

Unlike conventional banks which continued to progress over time, the Islamic banking concepts which were pioneered in the early years of Islam failed to expand into a complete banking system. Homoud (1985) suggests that the dark ages of the European Continent was a cause for the backwardness, not only in European but also in Islamic countries, leading to the severance of every link with all forms of Islamic banking practice which had existed in earlier times.

Islamic banks in present times were created in conjunction with the Islamic resurgence which took place within many Islamic communities especially at the end of 1960s and in the early 1970s. One of the most important issues which were widely discussed during that period was the transformation of the economy from a capitalist basis to an Islamic foundation. Since the elimination of interest has generally been the first step for the Islamisation of the economy, it is perhaps only natural that the formation and operation of Islamic banks were given the most attention (Khan and Mirakhor, 1987).

The establishment of Mit Ghamr Local Savings Bank in 1963 in a provincial rural centre in the Nile Delta of Egypt marked a new milestone in the revolution of the modern Islamic banking system. This bank was considered to be the most innovative and successful experiment with interest-free banking. The bank provided banking services such as deposit accounts, loan accounts, equity participation, direct investment, and social services. Although these services are considered basic banking services, it was nevertheless sufficient to meet the banking needs of the surrounding community. Besides its ability to prevent customers from going to money-lenders for financial assistance, this bank was able to instill a sense of belonging among its customers. These were the contributing factors towards its success.
One of the most important contributions made by this bank to Islamic banking history was that it proved to the Muslim community that there was an alternative to the conventional banking system. However, the turbulent political situation in Egypt adversely affected the bank. Its operations were consequently undertaken by the National Bank of Egypt and the Central Bank in the second half of 1967. As a result of this action, the interest-free concept was abandoned and Mit Ghamr's operations again reverted to an interest-based system. In 1971, under the regime of Mr. Anwar Sadat, the interest-free concept was revived and a new institution by the name of Nasser Social Bank was established to carry out businesses based on Shariah concepts which were previously practiced by Mit Ghamr.

Although Mit Ghamr had to cease operations before reaching a maturity period and before it was able to extend services to all business sectors, it nevertheless signaled to the Muslim community that Islamic principles were still applicable to modern day business. This phenomenon awoke Muslim scholars around the world. These scholars started studying and examining the operations of this pioneering bank.

Scarcity of literature and the absence of complete Shariah law guidelines often hampered their effort. Nevertheless, moved by the resurgence of Islam, Muslim scholars continued their struggle to establish Islamic banks in their own respective countries.

Realising the scarcity of resources, the first task to be carried out was to formulate the theoretical frameworks and guidelines on practical aspects of Islamic banking. These tasks were vested in Muslim theologians and economists. Finding Muslim economists who possessed an in-dept knowledge in Shariah laws was indeed a difficult job. In many instances, those who possessed knowledge of Islamic laws were non-economists and vice-versa. To complicate the matter, most of the Muslim economists were Western educated and did not
possess knowledge in Islamic economics. In Pakistan, for example out of the 19 members of the Council of Islamic Ideology, i.e. the first body set-up by President Zia-Ul Haq whose task was to develop a framework for the elimination of interest from the economy, only one member could be labeled as an expert in this field. Eleven of them received education from a madrasa (religious school) (Gieraths, 1990). All of these initial difficulties, however, were overcome, especially where the government was also playing a very supportive role in promoting the ideas of establishing an Islamic bank.

The initial step in establishing an Islamic bank in various countries was normally undertaken by private initiatives. The late King Faisal bin Abdul Aziz Al-Saud of Saudi Arabia, made a major contribution toward Islamic economics by initiating the establishment of the Organization of Islamic Conference (OIC). Under His Majesty's leadership and initiative, Muslim countries were urged to establish Islamic financial and economic institutions which were free from riba (Ali, 1988).

The second conference of OIC Foreign Ministers which was held in Karachi, Pakistan in December 1970, passed a resolution that a study needed to be made on the establishment of an International Islamic Bank for Trade and Development together with a Federation of Islamic Banks. The task of preparing a proposal for these institutions was given to experts from 18 Islamic countries. In presenting their report, the experts recommended the establishment of three institutions. The first institution was the International Islamic Bank whose function was very much similar to a normal commercial bank. Second was the Investment and Development Body of Islamic Countries whose function as an investment institution, and finally the Association of Islamic Banks was proposed as a consultative body in the field of Islamic economics and banking. The experts also recommended that the institutions to be established must be based on participation schemes linked with profit-and-loss sharing (Ali, 1988).
In a meeting which was held in Benghazi, Libya in March 1973, the OIC Foreign Ministers examined the proposal for the establishment of the above institutions. It was decided that a financial and economic department should be set up within the Islamic Secretariat. In July 1973, a committee of experts from oil-producing Islamic countries met in Jeddah to discuss the establishment of an Islamic bank and a subsequent meeting was held in May 1974 to discuss the bank's charter, rules and regulations. The Finance Ministers of OIC, in their second meeting in August 1974, approved the draft of the bank's charter, rules and regulations. Finally, the Islamic Development Bank (IDB) was officially established in October 1975 with a founding membership of 22 Islamic countries. This bank is located in Jeddah, Saudi Arabia and currently has more than 50 members countries. Besides providing financial assistance for the development purposes needed by members, this bank also extends its assistance to member countries who wish to establish an Islamic bank on their own. IDB also plays an important role in conducting and promoting research, especially in the area of Islamic economics, banking and finance.

The International Association of Islamic Banks was established on 20 August, 1977. The heads of the member banks or their nominees were elected as a Board of Directors. As a non-profit organization, this Association provides assistance in the form of technical and expert support, that is, promoting Islamic banking activities, fostering growth, and enhancing cooperation among members. The Association has established a Higher Religious Supervisory Board to ensure that member bank operations are conforming to Shariah. The Board members include an experienced Grand Ulama (the learned class of religious and legal scholars) of Islamic jurisprudence and possess knowledge in finance and other finance related disciplines. One of the functions of this board is to study matters related to financial and banking operations and to issue fatwa (a ruling on a certain matter) on new economic questions (Presley, 1988).
Although the idea of establishing Islamic banks had been discussed in Islamic countries since 1970, the process of establishing interest-free institutions in individual countries varied considerably from one nation to another. Pakistan, Iran and Sudan, for example, converted their entire financial system to an interest-free basis. In another countries, however, Islamic banks operate side-by-side with interest-based banks.

The first Islamic bank to be set-up was Dubai Islamic Bank in 1975, that is, almost immediately after the establishment of the Islamic Development in the same year. In 1977, three more Islamic banks commenced business i.e. Faisal Islamic Bank of Egypt, Faisal Islamic Bank of Sudan, and Kuwait Finance House. The Islamic banks which were incorporated in the late 1970s and early 1980s are shown in Appendix 1.

Currently there are more than 150 interest-free institutions all over the world providing services which are compatible to those services offered by interest-based institutions. The range of services includes commercial banking services, merchant banking services, fund management activities, investment activities, and insurance business. Moreover, these interest-free institutions have now extended their operations to the Western world and serve the needs of Muslim as well as non-Muslim customers.

At the beginning of the new millennium, it is estimated that about US$170 billion existed in the Islamic banking system worldwide. A study of the experiences of Iran and Pakistan shows that the adoption of Islamic banking has not led to the collapse of the financial system as some had feared. There has been rapid

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2 The Islamic Banking System International Holding (now called Islamic Finance House), for example, was established in Luxembourg in 1978 and became the first Islamic financial institution on Western soil, followed by Dar al-Mal al Islami established in Switzerland in 1981. The Islamic Bank International of Denmark commenced operations in 1983. Islamic banks have also expanded their operation in countries of the former Soviet Union. Al-Baraka Group of Companies of Saudi Arabia now has its own bank in Kazakhstan and this group is also aiming to develop a joint-venture in Uzbekistan (Ariff, 1988).
growth of private sector deposits in Islamic modes in both nations, demonstrating that the system can be effective in mobilizing resources (Khan and Mirakhor, 1990).

The commitment of government plays an important role in assisting the development of the Islamic financial system. In Malaysia, for example, the government has given its full support to the development of an interest-free financial system functioning side-by side with the conventional system. As at end of 2000, a total of 44 Islamic banking products and services were successfully developed by Bank Negara Malaysia, the Central Bank and a total of 49 financial institutions participated in offering Islamic banking services through the “Islamic Banking Scheme” (Bank Negara Malaysia, 2000).

1.2 The Objectives and the Philosophy of Islamic Banking

As in the case with conventional banks, profitability is considered as one of the important objectives of Islamic banks. Contrary to conventional banks, Islamic banks are expected to include social and moral aims as well as profit in their objectives. This is in line with the main purpose of their existence that is to promote, foster and develop banking services and products based on Islamic principles. The main principles of Islamic banking comprise of prohibition of interest in all forms of transactions and undertaking business and trade activities on the basis of fair and legitimate profit. Islamic banks are also to give zakat (wealth or alms tax) and to develop an environment which benefits the whole society.

Nevertheless, like any other business entity, Islamic banks are expected to make a profit from their operations. It is considered an injustice for Islamic banks if they are unable to provide sufficient returns to the depositors who entrusted their money to them (Mirakhor, 1987). Therefore, while ordinary business institutions are likely to place profit as their primary objectives, Islamic banks have to
incorporate both profit and morality into their objectives. For example, Dar Al-Maal Al-Islamic Trust, i.e. the holding company for Faisal Islamic Bank of Bahrain and another 25 financial and business companies operating on the basis of Shariah in 15 countries around the world, established the following objectives for its group of companies:

(a) To put before to all Muslims, contemporary Islamic financial services, helping to execute their financial dealings in strict respect of the ethical individual and social values of Islamic Shariah, without contravening the heavenly imposed prohibition of dealing in riba (interest or usury).

(b) To serve all Muslim communities in mobilising and utilising the financial resources needed for their true economic development and prosperity within the principles of Islamic justice assuring the right and obligations of both the individual and the community.

(c) To serve the "Ummat Al Islam" (Islamic communities) and other nations by strengthening the fraternal bonds through mutually beneficial financial relationships for economic development and the enhanced environment for peace.  

(Faisal Islamic Bank of Bahrain, 1993).

Further examples of the objectives of selected Islamic banks in various Muslim countries are presented below.

Bank Islam Malaysia Berhad (BIMB), Malaysia:

"To provide banking facilities and services in accordance with Islamic principles, rules and practices to all Muslims as well as the population of this country. The Islamic principles, rules and practices are essentially those belonging to the body
of Islamic principles on commercial transactions (ahkam al-muamalah al-Islamiah) that relate to banking and finance. The bank’s efforts to provide these banking facilities and services are undertaken within the framework of its viability and capability to continuously grow and expand”.

(BIMB, 1985).

Kuwait Finance House (KFH), Kuwait:

"To conduct all banking operations and services for its own account, or for the account of third parties, without practicing usury, whether in the form of interest or in any other form. To carry out direct investments or purchase or finance projects or activities owned by others, on a non-usurious basis”.

(KFH, Memo and Articles of Association, 1977).

Dubai Islamic Bank (DIB), The United Arab Emirates:

"The main objective or an Islamic bank is to prohibit the Muslims from dealing with interest or usury which has been strictly prohibited by Allah and to protect them from one of the biggest sins”.

(Undated DIB information leaflet).

As an institution whose foundations are based on religious doctrines, the establishment and operation of Islamic banks has raised many theoretical and conceptual considerations.³

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³ The Islamic economic order is based upon a set of principles found in the Qur’an. No matter what aspect of the Islamic economic order is introduced for practical operations it has to base itself on the Qur’anic concept of social justice. The Islamic financial system, therefore, cannot be introduced merely by eliminating riba but only by adopting the Islamic principles of social justice and introducing laws, practices, procedures and instruments which help in the maintenance and dispensation of justice, equity and fairness. (Ali, Directory of Islamic Financial Institutions, pp. 3-13).
The objectives and philosophies of Islamic banks thus in line with the revelations in the Al-Qur'an. As an entity that is established within the ambit of Islamic law, an Islamic bank is expected to be guided by these philosophies. From the religious prospective, the establishment of an Islamic bank is considered a righteous move for two reasons. Firstly, its existence is in line with the divine revelation, i.e. to involve in trade. Secondly, Islamic banks provide an avenue for Muslims to perform banking business in the Islamic way i.e. free from any element of usury. As stated in Al-Qur'an in verse 275 of Chapter 2 (Surah Al-Baqarah):

“But Allah has permitted trade and forbidden usury...”

Eliminating the element of usury in the banking system is only part of Islamic business principles. Islamic banks are expected to conduct their business with the objective of making profit and at the same time must conform to Islamic business principles. They must also observe the rules and laws which are directly imposed on individual Muslims. Otherwise, they should not define themselves as Islamic entities. Nevertheless, whatever law is imposed on Muslim individuals is indirectly applicable to Islamic banks.

The principles of Islamic business include honesty and the belief that trade is to be conducted in a faithful and beneficial manner. Islam conceives trade as an honest effort, an earnest endeavour, and a human striving for earning one's rightful livelihood. Trade manipulations and malpractices aimed at earning undue profit through operations like hoarding, black-marketing, profiteering, short-weighting, hiding the defective quality of merchandise, and adulteration cannot be regarded as honest trade (Siddiqi, 1997). The Prophet (pbuh) was once conferred the title of “al-amin” or trusted because of his honesty in all dealings. The operations of Islamic banks, therefore, are based on the concepts of honesty, justice and equity as practiced by the Prophet (pbuh).
In the process of conducting business, Islamic banks seek to bring about a lasting balance between earning and spending in order to achieve the target of the betterment of the whole community. Islam has always emphasised the lawful earning of livelihood. All unlawful means of acquiring wealth are prohibited. Chapter 4, verses 29 and 30 (Surah Ar-Rum) of Al-Qur'an states:

"Oh you who believe! Eat not up your property among yourself in vanities; but let there be amongst you traffic and trade by mutual goodwill; Nor kill (or destroy) yourself: for verily Allah has been to you most merciful. If any do that in rancour and injustice- soon shall We cast them into fire: and easy it is for Allah."

In terms of spending, Islam demands that its followers spend money for the welfare of the people and not for wasteful or pleasurable activities. This directive is given in verse 219 of Chapter 2 (Surah Al-Baqarah) of Al-Qur'an which says:

"They ask thee concerning wine and gambling. Say, "In them is great sin, and some profit, for men; but the sin is greater than profit." They ask thee how much they are to spend; say "what is beyond your needs." Thus doth Allah make clear to you His sign; in order you may consider."

In dealing with their customers, Islamic banks are expected to conduct the transactions for the benefit of both, i.e. the banks and the customers, and to uphold the concept of justice. In Chapter 16 (Surah An-Nahl) verse 90 of Al-Qur'an, it is states:

"Allah commands justice, the doing of good and liberality to kith and kin, and He forbids all shameful deeds, and injustice and rebellion: He instructs you, that you may receive admonition."
This verse requires Muslims to uphold justice irrespective of any blood relationship or status. Applying this verse to a business context, Islamic banks should treat their customers equally. This concept of justice is extended by Islamic banks when imposing charges on customers and also when fixing profit-sharing ratios either with their investors or with their business partners. This philosophy is also reinforced by verse 87 of Chapter 5 (Surah Al-Maa-idah) of Al-Qur'an:

"Oh you who believe! Make not unlawful the good things which Allah has made lawful for you, but commit no excess; for Allah loveth not those given to excess."

Mannan (1986) is of the opinion that, in an Islamic social system, welfare is maximised within the framework of Al-Qur'an and Hadith if economic resources are allocated so that it is impossible to make any one individual better off by any rearrangement of resources without making anyone or others worse off. Anything which is not expressly prohibited in Al-Qur'an and Hadith but is consistent with the spirit of the same may be styled as Islamic. Mannan (1986) believed that it is not harmful for Islamic banks to carry out business activities as long as these activities are not prohibited in Al-Qur'an or Hadith.

While making profit from the business is allowable in Islam, the accumulation of profit without utilisation for the betterment of the community is forbidden. Because of this revelation, Islamic banks are expected to be more sensitive to the needs of society, promote more social programs and activities and make contributions towards the needy and poor families.

Islam prohibits accumulation of wealth or its unrestricted possession by individuals exclusively in their self-interest. Besides that, Islam commands that even wealth which is earned by the right means should not be hoarded in selfish
interest because it would impede the growth of the economy, thus creating social imbalance. Verse 180 of Chapter 3 (Surah Ali-'Imran), says:

"And let not those who covetously withheld of the gifts which Allah has given them of His Grace, think that it is good for them; nay it will be the worse for them; soon shall the things which they covetously withheld be tied to their necks like a twisted collar."

Again in verses 1 to 4 of Chapter 104 (Surah Al-Humazah) it is repeated:

"Woe to every (kind of) scandal monger and backbiter, who pileth up wealth and layeth it by, thinking that his wealth would make him last forever! By no means, he will be sure to be thrown into that which breaks to pieces."

Three vices mentioned by the above verses are condemned in the strongest terms: (i) scandal mongering, talking or suggesting evil of men or women by word or innuendo, or behaviour, or mimicry, or sarcasm, or insult; (ii) detracting from a person's character behind their back, even if the things commented are true, where the motive is evil; (iii) accumulating wealth, not for use and service to those who need it, but in miserly hoards, as if such hoards can prolong the miser's life or give him immortality; miserliness is itself a kind of scandal. The revelations in Chapter 104 serve as a reminder to those who manage Islamic banks to be cautious in managing the assets of the banks. Islamic banks are prevented from accumulating wealth without any purpose. The wealth should be spent on the needy and for the betterment of the whole society. Failing to conform with the instructions of Allah means there is a great possibility that the wealth accumulated by the banks will be destroyed. The destruction may be in the sense that the bank will not be able to make profit and ultimately have to cease business.
Al-Qur'an in many of its verses indicates the principles which serve to guide Islamic banks in their practical affairs. To become involved in business is highly encouraged by Islam, but the business must be conducted on the basis of equity and justice. Islamic banks are prevented from engaging in business activities forbidden by Islam. During the course of conducting a business, every customer must be treated equally and lavish spending is not allowed. Islamic banks are also expected to make a profit from their business. This profit, however, is not to be accumulated without any specific reasons. Instead, Islam encourages its followers to spend for the needy and for other socially permitted activities.

1.3 Sources and Uses of Funds

There are three sources of funds for Islamic banks, namely, contributions made by the owner(s), short-term liabilities\(^4\) and depositors' money. The nature and the amount of contributions made by the owners are subjected to the laws and regulations which control the formation of a particular Islamic bank. As suggested by Siddiqi (1997), the bank should be established on the principles of Sharikat Inan in which two or more persons participate in an enterprise with a fixed amount of capital agreeing that they will work jointly and share in profit or loss proportionately. In reality, however, due to the large amount of capital which is needed prior to the establishment and commencement of a banking business and because of other advantages, many Islamic banks, especially in countries where laws are Western based, are established as public limited companies. As a public limited company, the total amounts of capital allotted and paid by the shareholders is not more than 10 percent of the total assets held by the Islamic bank.

\(^4\) Although short-term liabilities are considered as one of the sources of funds for Islamic banks, the amount contributed by items such as other creditors, and others payable are generally insignificant to the banks.
As in the case of conventional commercial bank, virtually the entire funds for the investment operations of Islamic banks derived from its customers' deposits. The two main categories of deposits from the bank's customers are the non-investment and investment deposits.

In the case of non-investment deposits, the depositors enter into a contract to place deposits with the bank for safe-keeping, and the bank, as a trustee, provide a guarantee that such deposits will be returned to the depositors on demand. The deposit balances thus represent a direct liability of the bank. The bank would maintain full liquidity cover against the balances of such deposits. If it is the will of Allah that the bank should be liquidated, the depositors are guaranteed that their claims shall be given priority over all other liabilities of the bank. The depositors on their part will expressly give their consent to the bank to invest their deposit balances in any form it deems fit. Islamic banks accept non-investment deposits in the form of current accounts and savings accounts.

Customers operating current account⁵ enjoy the normal facilities as offered by the conventional commercial banks such as the use of cheques to draw on their balances in the account and to effect transfers through the account. In return for providing such services, the normal service charges, including stamp duty, shall be levied on customers, as is normally done by ordinary commercial banks.

The other type of non-investment deposits is savings account.⁶ The depositors in this category are those who hold money primarily because of precautionary motives. The savings account holders will not be entitled to any share of the bank's profits. The bank may, however provide gifts to the account holders as a token of appreciation for keeping their money with the bank.

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⁵ Principles of qard hassan and wadiah are the principles adopted by Islamic banks in dealing with current account facilities. The bank will not distribute profits to this type of accounts.
⁶ Principles of wadiah, mudharabah and qard hassan are the alternatives available for the Islamic banks which choose to offer this kind of facility.
The second category of deposits in the Islamic banking system is an investment deposit. Islamic banks accept investment deposits based on the Islamic contract of Mudharabah. In this contract, depositors place a specified sum of money for a stipulated period with the purpose of participating in the profits from the bank's investments. The bank is thus entrusted to utilise these deposits in investment projects that it finances. They are a few alternatives available within this type of deposit. The bank would provide no guarantee or fixed return on the amount deposited. Customers who hold their funds in this investment deposit will be treated as if they were shareholders of the bank and are entitled to a share in the profits or losses made by the bank.

The agreement on how the profit or loss will be distributed between the bank and the depositor is made at the beginning of the deposit period and cannot be amended during the tenure of the deposits, except by the consent of both parties. The distribution of profit to the depositors may be on a quarterly, half-yearly, or yearly basis and advance notice is required for those who wish to withdraw the funds before the maturity date.

The Shariah also permits Islamic banks to raise funds7 by way of issuing investment certificates that carry no fixed return. These certificates are issued either directly to the depositors or through the Islamic inter-bank money market. The tenure of these certificates would vary from one to five years or even more. The principles of mudharabah and qard hassan are applicable to this kind of facility. In applying the principle of mudharabah, the reward for the depositors is based on the bank's annual profit, whereas under the principle of qard hassan, the reward is entirely dependent upon the bank's discretion. The sample of

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7 As in the case with conventional banks, funds received are used by Islamic banks for various purposes. Basically, the usage of these funds is represented by the types of assets held. The assets held by Islamic banks may be divided into two broad categories, frequently called earning assets and non-earning assets. Earning assets are the two balance sheet items called financing and investment. Non-earning assets consist of the total reserves of the bank (statutory reserve and other reserves), cash and bank balance, and financing under the principle of qard hassan.
sources and application of fund and profit distribution of BIMB is attached as Appendix 2.

As entities established on religious foundations Islamic banks are expected to abide by whatever rules and regulations imposed by the Al-Qur'an and Hadith. Islamic banks are not guided solely by profit maximising motives. Their utmost objectives is the betterment of the ummah (community) and their overall business philosophy is based on justice and equity. Because of this philosophy, Islamic banks, subject to the availability of funds, participate in both new or existing projects as long as the proposed venture is viable and profitable.

Shariah strictly prohibits non-commodity trading. Since the Shariah considers money as a non-commodity item, granting loans to customers for profit is therefore unlawful (Siddiqi, 1997). In most cases, the funds will be used through equity participation or partnership. Principles of mudharabah, musharakah, and murabahah are commonly applied by Islamic banks in assisting their commercial customers. Principles of ijarah and ijarah wa-iktina are used for hire purchase and leasing facilities. The principle of qard hassan is for ordinary customers who need financial assistance for buying durable goods and other personal needs. Other banking services such as letters of guarantee, letters of credit, remittance services, travellers' cheques, and safe deposit boxes are considered as fee-based services.

In regard to the application of funds, Islamic banks sometime face operational problems. The first problem regards the reserve and liquidity requirements imposed by the central bank. There is a conceptual distinction between the deposits of an Islamic bank and the deposits of a conventional bank from the viewpoint of the liquidity and statutory reserve requirements for these deposits. The hypothetical question here is whether the same ratios should be applied to both Islamic and conventional banks. Some commentators believe that because the nature of the Islamic banks' operations is different from the conventional
banks, they should be exempted from liquidity control procedure (El-Ashker, 1990). For example, investment deposits of the Islamic banks are kept for a specific period, from a few months to a few years, before which the deposit can be withdrawn. Therefore, Islamic banks are in a better position to plan cash budgets and better able to monitor the withdrawal schedule. Similarly, Islamic banks do not guarantee both returns and the principal amount of the invested amount, thus the question of guaranteeing the safety of the depositors' money does not arise.

The second problem faced by Islamic banks is in case of shortage of funds. In the conventional banking system, one of the functions of the central bank is as the lender of last resort and the assistance given may be in the form of rediscounting of treasury bills, Government securities and other certificates or through direct borrowing. However, Islamic banks are not able to take opportunity of drawing on these facilities in view of the element of interest in one way or another. Similarly, Islamic banks are not able to become members of inter-bank markets in which the instruments traded are interest-based.

Without sufficient financial instruments that are based on Islamic principles and are developed by the Islamic financial system, Islamic banks face problems not only in cases of shortage of funds but also in the case of excess liquidity. Without sufficient avenues for the Islamic banks to make investment, it deprives them not only of profit-making opportunities but also restricts their ability to meet the liquidity requirement ratio imposed by the central bank.

A third issue regarding the method used by Islamic banks in determining the percentage of mark-up or mark-down in cost or price when dealing with their customers. In discussing the validity of the percentage used by the Islamic banks in their operations, the Habib Bank of Pakistan argued that the percentage is just a mathematical device to measure the relationship between two quantitave variables and it has nothing to do with halal (licit) or haram (illicit) issues. In its
elaboration on this matter the Habib Bank stated that halal thing remains halal whether it is measured in percentage terms of otherwise. Similarly, a haram thing remains haram whether it is measured as a percentage or not (Habib Bank, 1985). However, this should not necessarily be the case. Islamic banks, in their endeavours to provide services governed by principles of justice and equity, should not make any comparison with the interest rate imposed by a conventional commercial bank. The percentage of mark-up or mark-down should be carefully studied and in most cases the rate should not the priced on an equal footing with the interest rate used by conventional commercial banks.

Another important issue that should be studied carefully by Islamic banks is the extent to which they should be involved in the running of the businesses in which they have an interest. For example, Siddiqi (1997) believes that in the case of mudharabah, the bank should allow the entrepreneur, in addition to his own capital, to procure further capital from others on a similar principle, and that he should also be able to purchase or sell goods on credit within the limitations of the total capital and to procure short-term loans for investment in the business. The nature of the business should, certainly, be settled in principle, but the entrepreneur should be accorded the fullest freedom for working out the details. The entrepreneur, however, will not be allowed to acquire long-term loans for the business for the simple reason that this will increase the financial liabilities of the partnership beyond the limits of the jointly covered capital.

1.4 Laws and Regulations for Islamic Banking

Islamic banks in any country around the world must conform to two types of laws. Firstly, Islamic financial institutions must conform to Islamic principles and laws. Without observing and following the foundations and rules as stipulated in the various sources of Islamic law, no institution can claim to be an Islamic bank. Islamic laws are usually referred to as the Shariah laws. Another type of law to be conformed to by Islamic banks are the laws and regulations imposed by the
government of their domiciled country. These laws are also known as positive laws (Haron, 1997).

With regard to the Islamic banking system, Shariah does not provide any single decree in which it gives all the rules and guidelines to be followed by the Islamic banks. The rules and guidelines, however, are abundantly described by the various sources of Shariah law. Shariah laws are derived from four sources, namely, Al-Qur'an, Hadith, Ijma and Qiyas.

As stated by Mannan (1986), the uniqueness of Islamic law lies in its comprehensiveness of principles, valid through the ages in respect of the whole mankind. The whole basis of Islamic law is a standing and perceptual miracle, a miracle in the sense that Islamic law may not only be compared with the law of tides but also with the simple and exact law of gravitation. This is because, while Islamic laws have always been found to yield new truths and fresh guidance in every age and at every level, guidance has also been furnished to mankind through a series of fundamental and eternal revelations vouchsafed by Allah to the Prophet (pbuh).

According to Maududi (1983) the main objective of Shariah is to construct human life on the basis of marufat (virtues) and to cleanse it of munkarat (vices). The term marufat denotes all the virtues and good qualities that have always been accepted as "good" by the human conscience. Conversely, munkarat denotes all the sins and evils that have always been condemned by human nature as "evil". In short, the marufat is in harmony with human nature and its requirements in general and the munkarat are just the opposite. The Shariah gives a clear view of these marufat and munkarat and stresses them as the norms to which individual and social behaviour must conform.

Positive laws are the laws that are given by civil authority, as distinct from the moral or sacred laws given by God or with God's guidance. In most cases,
positive laws in Muslim countries originated in Western countries. Those Islamic banks which are established in a secular country not only have to adhere to all the Shariah laws, but must also conform to the civil laws of that particular country, in most cases under the supervision of that country’s central bank. For example, in Malaysia, the establishment of Islamic banks is governed by the Companies Act 1965, and their operations are subjected to the Islamic Banking Act 1983. Islamic banks, therefore, must conform to all requirements as stipulated in both Acts. In Iran, the Law for Usury-Free Banking 1983 provides various provisions relating to the Islamisation of the entire banking system. In Jordan, the government passed the Jordan Islamic Bank for Finance and Investment Law No. 13 of 1978 prior to the establishment of the Jordan Islamic Banks and the functions and activities of the bank are specified by this Law (Haron, 1997).

1.5 Summary

Islamic banking is broadly defined as a banking system whose operations are not only governed by the Shariah that prohibits interest but which are conducted in accordance with the value system of Islam. Islamic banks in present times are considered as the end product of the Islamic resurgence which took place in many Islamic countries during the late 1960s and in 1970s. Nevertheless, the existence of Islamic banking products can be traced back to the early days of Islam. While conventional banking products started to emerge with the revival of commercial activities during the 13th century, Islamic banking products were not reinvigorated and as a result of colonialisation the banking system in Muslim countries was based on conventional banking rules.

The establishment of the Mit Ghamr Local Savings Bank of Egypt in the 1960s marked a new milestone in the modern world of Islamic banking. Currently there are more than 150 interest-free institutions all over the world, especially in Muslim countries, providing services which are compatible to those services
offered by interest-based institutions. The range of services includes commercial banking services, merchant banking services, fund management activities, investment activities, and insurance businesses. Islamic financial institutions have now extended their activities to the Western world and serve the banking requirements of both Muslim and non-Muslim customers.

As in the case with conventional banks, profitability is considered as one of the important objectives of Islamic banks. Contrary to conventional banks, Islamic banks are expected to include social and moral aims as well as profit in their objectives. This is in line with the main purpose of their existence that is to promote, foster and develop banking services and products based on Islamic principles.

As institutions whose foundations are based on Islamic religious doctrines, Islamic banks are expected to conform to Islamic business principles. Eliminating the element of interest in their operations is only one part of the total Islamic business ethos. Other principles include (i) to engage in legitimate and lawful businesses; (ii) to fulfil all obligations and responsibilities; (iii) business must be based on the concepts of honesty, justice and equity; (iv) overspending and wastage are prohibited; (v) wealth must be used in a proper and orderly manner; (vi) to help and assist the needy; and (vii) transactions must be properly executed.

The main source of funds for Islamic banks is from deposits made by customers. Basically there are two main categories of deposit facilities provided by Islamic banks, namely non-investment deposits in the form of current accounts and savings deposit and investment account facilities. While current account facilities are provided for customer convenience, savings accounts are designated for those who wish to save money and at the same time earn income. Investment accounts are for those who keep money for investment motives.
In the case of current accounts, no returns will be given to depositors and they are allowed to withdraw their funds at any time without notice. The current account facilities are usually governed by the principle of wadiyah (trust) or qard hassan (benevolent loan). Returns to savings and investment account holders are not pre-determined and usually these returns are based on profit-sharing concepts or mudharabah. Depositors only know their rewards at the end of the deposit period.

Funds collected from the depositors are used for financing activities based on allowable Shariah principles. There are three categories of principles, namely: (i) principles that are based on profit-sharing; (ii) principles that are based on mark-up; and (iii) principles that are based on free of charge transactions. Other banking services such as letters of credit, letters of guarantee, remittance services, travellers' cheques, buying and selling currencies, and safe-deposit boxes are also available at Islamic banks. These services are considered fee-based activities.

Islamic banks have to conform to two types of laws, Shariah law (Islamic law) and positive law. With regard to the Islamic banking system, Shariah does not provide any single decree in which it gives all the rules and guidelines to be followed by Islamic banks. The most important matter directly related to the banking system is the prohibition of interest. There are a lot of verses in Al-Qur'an which prohibit Muslims from associating themselves with interest. Similarly, there are many Hadiths describing the Prophet (pbuh) being totally against those who give and take interest.

Positive law is given by a person of authority or the government of the country. With the exception of countries such as Malaysia, Turkey, and Iran where a special law was decreed prior to the establishment of interest-free institutions to govern the operations of these Islamic banks, no special law was promulgated in other countries. There are, however, special laws decreed by countries such as
Jordan, Sudan and Egypt, but these laws only apply to a specific Islamic bank. Besides observing the special laws, Islamic banks must also conform to other laws which directly regulate the entire country's financial system and laws for those activities which an Islamic bank in involved in.

References

6. Dubai Islamic Bank (undated), Information Leaflet, Dubai (United Arab Emirates).


