CHAPTER 2

Islamic Banking Services – An Overview

2.1 Introduction

This chapter presents an overview of Islamic banking and financial institutions in practice. It presents attempts to implement the theoretical operating models developed by Islamic economists. The majority of Islamic banks are less than a decade old. Yet in spite of its newness the institution of Islamic banking operates over a substantial part of the world, largely in Muslim countries. This chapter provides a catalogue of such Islamic banks and financial institutions. It will be observed that there are several types of Islamic financial institutions in operation including development, pure savings and commercial banks, as well as investment companies which operate under diverse environments from a monopoly decreed by governmental order to a fully competitive setting where conventional banks coexist. This chapter also distinguishes between conglomerate type ventures and individual banking operations, and then provides a worldwide tour of Islamic financial institutions on a country by country basis (according to alphabetical order), except Iran, which will be discussed separately later. The chapter, therefore, is an overview of the performance of Islamic banking worldwide, how Islamic banks and Islamic nations have attempted to disseminate Islamic banking operations. It reflects on the potential of Islamic banking as a new institution in the development of financial systems as well as provides some insights into the problems encountered by this new institution that have implications for its viability.

There are various types of Islamic banks that are already operating of which the following categories can be discerned:

1) The early experiments with socially oriented banks
2) The Islamic Development Bank
3) Islamic commercial banks founded on national and international bases including Islamic investment and holding companies (Ahmad. K, 1998)

2.2 Socially Oriented Banks

The first Islamic bank was established in Mit Ghamr in the Nile Valley of Egypt in 1963 in the form of a rural social savings bank. The bank was created to assist low income farmers to pool their resources and cooperate for a variety of purposes such as house repairs, simple handicraft equipment, tools and farm animals for developing their agricultural farms. It was fairly successful in mobilizing resources and effecting productive lending and utilization of funds in its early years and contributing to the development of the village. Within three years the number of depositors increased from about 1000 founding members to 60000. Except for a service charge, no interest was paid on deposits, but in order to receive an interest-free loan a borrower had to have a specified minimum amount in a savings account for at least a year. Depositors and borrowers therefore belonged to the same group. Problems of rural indebtedness were reduced and borrowers no longer had to depend on the high interest money lenders (Naggar.A, 1998).

Mit Ghamr's success was such that in 1967 four more branches and eight similar banks were opened in eight other provinces. The number of savings banks reached nine and the number of depositors in all banks increased from zero in 1963 to 357637 in 1967, while total deposits amounted to 956538 Egyptian pounds. However, in spite of its popularity and initial success the Mit Ghamr bank encountered difficulties in the face of increasing demand for its services and its inability to recruit the staffing needs with their only revenue coming from service charges, as the bank did not have a share in the profits made by borrowers. Its location made it difficult to sustain staff interest and it was not politically supported in its later years as authorities saw its role encroaching onto their social functions and consequently caused it to come to an end.

The Mit Ghamr experiment was followed by the establishment of the Nasser Social Bank in Cairo in 1972 to promote social services for low income groups. The bank was sponsored by the Egyptian government with an initial paid capital of 1.4 million Egyptian pounds. It also came under the control of the Central Bank of Egypt. Previous outstanding commitments by the Mit Ghamr Savings Bank were honoured by the new bank. In general, the emphasis was on short term lending to ensure the rotation of funds. In addition only depositors were allowed to borrow for social purposes. The financial services offered included interest free loans to low income groups, pilgrimage finance, and social insurance funds. Loans were often used for housing, but borrowing for speculative purchases of real estate and for redepositing in other banks for interest were prohibited. Islamic ethics under laid its operations.

Although the bank offered services besides savings and borrowing facilities, the bank was more in the nature of a social security organization than a commercial institution initially. Economic and commercial project financing on the basis of profit sharing began in the late seventies, and proved successful to the point that profits of $10 - $12 million were made annually between 1978 and 1980 (Wohler and Scharf.T, 1993). It strived to provide Islamic-based branch banking facilities for believers in as many locations as possible. By early 1980, it had 25 branches throughout Egypt with total deposits reaching 240 million Egyptian pounds ($345 million). The increase in deposits had resulted in the paid-up capital being raised to the authorized limit of 4 million Egyptian pounds ($5.8 million) and was expected to increase in the future.

In a study of Islamic banking operations of the Mit Ghamr Savings Bank and the Nasser Social Bank, Rodney Wilson commented:

“The evidence from Egypt appears to suggest that the established banks do not appear to object to the competition which Islamic banks provide…. To some extent this is because the Nasser Social Bank has attracted a new kind of customer who hitherto did not use the commercial baking system but relied on traditional money lenders. It is the latter whose business is threatened….. This extension of the banking net to attract nonbanking clients was also the case with the Mit Ghamr Savings Bank. Furthermore, in so far as the Islamic banks directly invest in ventures themselves, they are providing a financial service which complements rather than threatens the conventional bank.” (Wilson and Rodney, 1995)

2.3 The Islamic Development Bank

The Islamic Development Bank (IDB) was established in 1975 with its headquarters in Jeddah, Saudi Arabia. It symbolized the pinnacle of an Islamic banking and financial system that was strongly advocated by the late King Faisal in the early seventies. His strong support enabled the Islamic conference organization to establish the bank in 1975. The bank was capitalized with twobillion Islamic Dinars (equivalent to two billion SDR) with membership from more than 40 Islamic countries (43 in 1985), with the biggest shareholders being Saudi Arabia (25%), Libya (16%), the United Arab Emirates (14%) and Kuwait (13%). The objective was to foster economic development and social progress in Muslim countries in accordance with Islamic Law (Shariat) principles, through provision of equity capital and interest free loans for development projects, technical assistance and trade finance. The IDB had a host of subsidiary objectives provided in its charter and has moved toward realizing them. One objective to provide a fund for assistance to Islamic communities in non-member non-Muslim countries still remains only on paper. Another unrealized objective was to accept deposits besides equity capital from governments, institutions, and even individuals for utilization in projects and sharing in the profits arising.

The main emphasis by IDB has been to promote trade between member countries, which initially accounted for less than 10 percent of total trade- the result of member countries' exports being primarily of primary commodities while their imports were manufactured and capital goods from the west. IDB had made great progress toward realizing this objective by providing interest-free trade finance and balance of payments support to poorer member countries to increase their import capacity. In such cases, IDB played the role of financial guarantor and was as subsidizer to the trade operation. Only a small service charge of 2-3 percent was levied to cover administrative overheads. Foreign trade financing accounted for 60 percent of the total IDB funds during the first decade of its financing operation. Funds were provided for short of its financing operation. Funds were provided for short to medium term periods of about 3- 5 years and predominantly for financing the import costs of crude oil, petroleum products, urea fertilizers, jute products, cotton yarn and palm oil between member nations.

The financing of projects, however, was hampered by a shortage of appraisal and supervisory personnel as well as the difficulty of effective control over whatever projects were undertaken. IDB's aim was not to provide funds for controlling equity participation as the bank did not wish to incur the resentment of host countries and did not want to have the responsibility of managing directly any particular project. Rather, it aimed to provide initial start-up participation financing of a transitory nature. Project investments undertaken included a poultry project in northern Yemen, a cement plant in United Arab Emirates, a textile operation in Pakistan, and iron ore extraction in Mauritania. The IDB had been consolidating its project operation as it did not intend to build up too diverse a portfolio. Instead it indirectly participated in industrial projects through wholesale financing by taking equity shares in financial organizations such as the national development banks in Jordan, Tunisia, Turkey and the Bahrain Islamic Bank, which themselves backed industrial projects.

Lease financing was another popular mode of financing employed by IDB with beneficiaries being Morocco (railways), Somalia (ships), and Pakistan (refining equipment) among others. By employing IDB'S funds, this allowed the member countries were allowed to used the lease and utilize their own funds for other development projects. As the lease contracts specified the terms and periods of the advance according to Islamic Law (Shariat) principles, there was complete certainty for both parties involved. This was one innovative mode of operation acceptable to Shariat that IDB and Islamic financial institutions employed to achieve economic growth and development in member countries, demonstrating the compatibility of Shariat with commerce and development.

A second broad objective was to promote cooperation among national Islamic banks in the exchange of experience and expertise. Toward this end, the Islamic Development Bank was instrumental in the creation of the International Association of Islamic Banks (IAIB) in August 1977 under the chairmanship of prince Mohammad A1 – Faisal A1-Saud of Saudi Arabia. The role of IAIB was to act as technical advisor, coordinate Islamic banking practices, standardize concepts and instruments, promote cooperation among national institutions, foster the growth of Islamic banking, and provide training to personnel and counseling services to members. A separate institute for training was later formed in 1982 called the International Institute of Islamic Banking and Economics, located in Lefkosa in the Turkish Federal State of Kibris in Cyprus. (Ahmad. K, 1999)

2.4 Islamic Commercial Banking

Commercially oriented Islamic banks began in the mid Seventies, offering an alternative as well as a supplement to conventional banking practices. As a fairly new creation, Islamic banks by conventional banking standards are still small in number and size- numbering about fifty and mainly with small authorized and paid up capital. Only the Kuwait Finance House was included in the Banker's list of the top 100 Arab banks in 1983. Not including the development oriented Islamic Development Bank, the total assets of Islamic banking and financial institutions stood at about $2 to $3 billion in 1983.

Islamic commercial financial institutions are of two categories. The first category constitutes the Islamic commercial banks, and includes among others, the Dubai Islamic Bank (1975), the Kuwait Finance House (1977), the Faisal Islamic Bank of Egypt (1977), the Faisal Islamic Bank of Sudan (1977), the Jordan Islamic Bank for Finance and Investment (2978), the Bahrain Islamic Bank (1978), the Islamic International Bank for Investment and Development, Egypt (1980), the International Islamic Bank of Dacca, Bangladesh (1982), Massraf Faisal A1 Islamic Bank of Dacca, Bangladesh (1982), Massraf Faisal A1 Islami, Bahrian (1982), Bank Islam Malaysia (1983) and the Faisal Finance House, Turkey (1985). The second category of Islamic investment holding companies includes the Islamic Investment Company, Nassau (1977), the Islamic Investment Company of the Gulf, Sharjah (1978), the Shariat Investment Services, Geneva (1980), the Bahrain Islamic Investment House, Amman (1981), the Dar al-Mal al-Islami (DMT) Trust, Bahamas (1981), the DMT Limited (Geneva) (1981), the Islamic Investment Company, Sudan (1982),the Bahrain Islamic Invest Company, Manama, and the Islamic Investment House, Amman. In addition, there are the Massraf Faisal Islami in Senegal, Niger and Guinea, and Turkey's first Islamic bank the Faisal Finance House of Turkey (2985). The functions of these institutions include undertaking investment of funds and generation of permitted (Halal) profits financial operations and spheres permitted by Islamic law (Shariat).

Islamic financial institutions are either financially independent or constitute part of a major financial group. Financially independent Islamic banks include the Jordan Islamic Bank, the Nasser Bank, and various national Islamic banks such as in Pakistan and Malaysia. The financially linked and controlled groups are mainly found in the Gulf States. The Dubai Islamic Bank, the Kuwait

Finance House, the Bahrain Islamic Bank, and the Bahrain Islamic Investment Company jointly participate in the establishment of new branches around the Gulf region (Ahmad, Sheikh, 2001).

2.4.1 The Conglomerates

A well-known group in the Jeddah based A1-Barakah Group was headed by Sheikh Saleh Abdullah Kamel with an authorized capital of $5 billion and a paid-up capital of $1.5 billion. Its subsidiaries include the Saudi-Tunisia Finance House, the A1-Barakah Investment and Development Company, Jeddah, the A1-Barakah Islamic Investment Bank in Bahrain, the A1-Barakah Nile Valley Company in Egypt and Sudan, the A1-Barakah Sudanese Islamic Bank, Khartoum, Sudan and the A1-Barakah Islamic Bank, Tunisia. The A1-Barakah Islamic Investment Bank Bahrain was opened in Manama in March 1984 with a capitalization of $200 million serving as an offshore banking unit for the group. It will absorb any surplus liquidity of other Islamic banks that are unable to handle a high increase in deposits. The A1-Barakah Sudanese Islamic Bank has an authorized capital of $200 million and a paid-up capital of $50 million jointly financed by A1-Barakah and Sudanese financiers. The group also has offices in Singapore, London and Baghdad and participates in the Islamic Banking System International (IBS), Luxembourg. The A1-Barakah Group plans to open branches in Turkey, Egypt and Malaysia. In terms of authorized capital alone, A1-Barakah has surpassed the Geneva based Dar a1-Ma1 a1-Islami (DMI) Group. A1-Barakah has an authorized capital of $5 billion of which $1.5 billion has been paid up, compared to $1 billion and $315 million respectively for DMI.

The DMI Group however is the more publicized Islamic financial conglomerate with Prince Mohammad A1-Faisal A1-Saun as its chairman. The DMI Group comprises both national and international institutions. The DMI was registered as a trust under the laws of the Bahamas with a management board consisting of 18 members. However, its operation is based in Geneva. About 70 percent of its capital is Saudi-owned. Among its subsidiaries are the Faisal Islamic Bank of Egypt, the Faisal Islamic Bank of Sudan and the Faisal Islamic Bank of Turkey. The DMI Group anticipates expanding its operation to other Muslim countries as well as Europe, U.S., and the Far East. Its plan includes the establishment of Islamic banks, Islamic investment companies and Islamic insurance companies in these locations. The Islamic commercial banks are capitalized between $20 to $50 million each, and the investment and insurance companies at $10 million each. In all cases, DMI holds 51 percent of the equity capital and the rest by local partners. Most of DMI's target areas are in the Middle East, North Africa and the sub-Saharan regions of Africa.

DMI began with West Africa in Senegal, Guinea, Gabon, Nigeria and Upper Volta, with whom protocol agreements were signed (except Nigeria) to establish DMI operations. With the exception of Gabon, a large Muslim population was found in these areas. The acceptance of DMI in principle by the many African nations owed largely to its policy of undertaking to be involved in project financing in these resource poor nations. In Sudan, DMI's project involved maize, sesame and cotton cultivation. Its subsidiary the Islamic Investment Company Sudan, was established in Khartoum in 1982 with an authorized capital of $10 million and a paid- up capital of $2.5 million of which DMI contributed 51 percent and Faisal Islamic Bank Sudan 49 percent. It started operations in 1983, participating in agricultural and industrial projects based on the principle of trust financing or profit losse sharing (Muzarebeh). In Guinea, DMI planned to finance a $100 million oil refinery; while in Gabon, DMI's activity was to be in housing construction and food manufacturing. Subject to the operating environment, DMI also considered prospects in Mali, Ivory Coast, Benin and Togo.

Up to March 31, 1985, funds managed by the DMI Group on behalf of clients, excluding the capital of DMI, were reported at $1.3 billion. Its insurance company in Bahrain, the Sharikat A1-Takafol A1-Islamia, was already in operation while the Faisal Finance Institution, established in Istanbul, Turkey, started operations in April, 1985. DMI's projects included joint commitment with Faisal Islamic Bank in Egypt for the manufacture of pharmaceuticals, detergents and plastics. Massraf Faisal A1-Islami Bahrain, which is owned by DMI and capitalized at $20 million, was the first offshore banking into which DMI ventured. It financed projects in Saudi Arabia in the area of transportation and production of chemicals and plastics, as well as trade financing for the importation of agricultural and hospital equipment, medical supplies, consumer goods and feedstock.

Another DMI subsidiary, the Massraf Faisal A1-Islami, Bahamas licensed in December 1982 with an authorized capital of $2 million operates in the parallel purchase and sale of currencies. The objective is to create an international institutional channel for DMI in order to carry out short term Islamic investment with major international financial institutions. (Ahmad.z et al, 1983)

2.4.2 National Islamic Banks in the Middle East

In **Bahrain**, the Bahrain Islamic Bank (BIB) was established in 1981 with an authorized capital of BD 23 million and a paid-up capital of BD 5.75 million. The bank recorded increases in net profits from BD 1.8 million in 1982 to BD 2.2 million in 1983 and BD 2.8 million in 1984. Returns to depositors in savings accounts averaged 6 percent – comparing favorably to the 3.5 percent interest rate offered by conventional banks. Dividends to shareholders were in the region of 12 percent. Deposits have increased by about 11.5 percent in 1984 with small savers constituting 30 percent of the depositors. BIB's subsidiary, the Bahrain Islamic Investment company, which began in August 1981 with a paid up capital of BD 5 million, expanded operations opening three branches, and was involved in trading, industrial and real estate financing and investments.

The other Islamic Bank in Bahrain, the Faisal Islamic Bank or Massraf Faisal Al-Islami Bahrain was incorporated in July 1982 and began operation in December 1982. Its project operations covered transportation projects for pilgrims in Jeddah as well as, brick manufacturing and agricultural irrigation in Saudi Arabia. For the year ending December 1983 it achieved a net profit of $ 880716. It reported satisfactory growth in 1984 with total funds rising to BD 63 million from BD 24 million in the previous year.

Egypt: The Faisal Islamic Bank of Egypt (FIBE) was established in 1977 as the first Islamic Commercial Bank in Egypt, given that the Mit Ghamr Savings Bank (1963) and the Nasser Social Bank (1972) were more in the nature of social banks. FIBE is jointly owned by Egyptian interest (51 percent) Saudis and others (49 percent). Its paid-up capital at the end of the 1983 financial year stood at $37.95 million compared to $29.6 million in 1982. In its seventh year of operation, FIBE had become one of the largest banks in Egypt. It had1.2 million accounts compared to 300000 in the next largest bank and an average of 30-

40000 accounts for Egyptian banks. The regular accounts saw a rise from $182 million in 1982 to $437 million the following year. Projects financed on trust or limited partnership (Muzarebeh), joint or unlimited partnership (Musharekat) and cost-plus pricing (Murabahah) bases increased by 54 percent to $1.27 billion in 1983 compared with $820 million in 1982. By the end of 1983, FIBE's total assets reached $1.5 billion a 51 percent increase from the $1 billion in 1982. Profits were distributed quarterly.

FIBE's development in the years up to 1985 has been slowed by the inaction of the authorities. It still awaits approval to open 13 branches that have been constructed. FIBE also has high reserve requirements of 25 percent of its funds imposed by the central bank, which is affecting its profitability since, unlike conventional banks, it cannot accept interest paid on these reserves. As depositors in Islamic banking are more in the role of investors than savers, the element of risk is to be shared and so the high reserve requirement is contrary to this concept. FIBE's inability to own fixed assets, due to restriction by the Central Bank, is also hindering its ventures in trade, industry and agriculture based on trust (Muzarebeh) and joint (Musharakat) principles of partnership. Despite the setbacks, FIBE had established 26 companies by the end of 1983 with a total capital of 112 million Egyptian pounds of which FIBE's share is 26 million. The activities covered financing internal and external trade, pharmaceutical manufactures, medical equipment importation, livestock, poultry and real estate investments and investments in industry and agriculture.

Jordan: Unlike most Islamic financial institutions in the Middle East which have external participation in ownership, the Jordanian Islamic Bank (JIB) for Finance and Investment is wholly owned by Jordanians. JIB was formed on November 28, 1978 with an authorized capital of JD 4 million, which has since been increased to JD 18.5 million. JIB operates both as a commercial and investments institution and engages in trade financing and project investment involving the construction of flats, schools and commercial buildings. JIB had a net profit of JD 593698 in 1983, lower than the JD 863868 it made in 1982. Dividend rate for 1983 was 8 percent while profit sharing rates ranged from 2.7 percent for savings accounts to 4.9 percent for investment accounts.

Kuwait: The first Islamic bank in Kuwait, the Kuwait Finance House (KFH), was incorporated in early 1977 and commenced operation in late 1978. Its capital stood at KD35 million, with shareholdings by the Kuwaiti Government (49%) and nationals (51%). As its name suggests, KFH's business goes beyond normal banking operations, as it is also an investment house. The activities of KFH consisted mainly of investments in properties and real estate, cooperative insurance, permitted (Halal) meat importation, and investment abroad in subsidiaries, the latest of which are the Turkish Finance House and the International Islamic Bank.

Until 1984, KFH deposit and profit performance were higher than expected. In its initial year of operation in 1978, KFH already made a profit, albeit a minimal KD 0.5 million. In 1979 profit rose to KD 3.4 million, and in 1980 to KD 9.6 million. Profit levels reached a high of KD52 million in 1982, before being hit by the recession and the slump in the stock and property markets in 1983 and 1984. In 1983, KFH's profit fell to KD42 million and was further reduced to KD28.5 million in 1984. KFH's assets which were about KD168000 in 1981, were assessed at KD800 million in 1984 of which more than half was in real estate that included two of the largest buildings in downtown Kuwait and several residential housing projects. This enabled total investments to reach KD760 million by the end of 1984, of which KD100 million were in foreign operations.

KFH's progress in attracting deposits was phenomenal up to 1983. Total deposits in 1983 surged to KD698 million from KD473 million in 1982. It came to the point that because profit in 1983 started to fall, a policy of restraining deposit growth to KD5000 on new deposits was instituted to safeguard the rate of return to existing depositors. In 1984, deposit acceptance was even suspended temporarily. The high growth in deposits owed both to reasons of piety and to the high profit sharing rates that KFH had declared to depositors during the early years of its existence, averaging 5 to 7.5 percent on savings accounts and 10 to 12 percent on investment accounts. The dividend rate to shareholders was approximately 20 percent.

In January 1985, as a result of the poor performance of its investments in the preceding two years, KFH made the unprecedented announcement that, as with the other financial institutions in the country which all had suffered from the stock and property market crises, no profit-sharing or dividend would be declared for the second year running. The announcement precipitated a spurt of withdrawals. A crisis of confidence was averted by the timely announcement by the Kuwaiti authority that KFH was financially sound and solvent and that the move not to distribute profits, which were placed into a reserve fund upon the direction of the central bank, was precautionary just as was required of other institutions in the country during the 1984-1985 period. KFH's reserves stood at KD58.7 million at end of 1984.

Saudi Arabia: It appears paradoxical that Saudi Arabia, the holiest of the Muslim nations, still awaits the introduction of its first Islamic commercial bank. The fact is that financial operations in Saudi Arabia have always been run on Islamic lines with interest paying and receiving strictly prohibited. Banks in Saudi Arabia do not carry the title of Islamic banks, as Saudi authorities did not see the necessity for them to do so when financial operations have been under Islamic governance. Still, the difference is that the few banks in existence either engage wholly or largely in the business of money exchange – catering to pilgrims and expatriates rather than acting as intermediating institutions that accept and utilize productively deposits to realize profits which could be shared. On that reason there is a basis for Islamic banking as existed elsewhere to be introduced in the country so that the benefit of intermediation on economic growth and development could be achieved. A proposal was made to introduce the first Islamic commercial bank in the country in 1985 by reincorporating the third largest financial institution in the country the Al-Rajhi company for Currency Exchange and Commerce to be known as the Al-Rajhi Banking Investment Corporation, with a paid up capital equivalent to $213 million and with 180 outlet.

There are currently 11 commercial banks operating in Saudi Arabia. The first bank allowed into the country was the Algemene Bank Nederland set up in Jeddah in 1925 to serve pilgrims from Indonesia and engaging wholly in money changing operations. Initially it did not accept deposits or grant loans. Foreign financial institutions, including those from the Arab states, were not given access into Saudi Arabia prior to World War II by King Saudi, with the exception of an Egyptian-Saudi venture called the National Commercial Bank (NCB) in 1938.

During the Forties, some deposit-taking operations were allowed, but money changing remained the main activity. Depositors kept funds in current accounts and there was no attempt to introduce savings schemes. The NCB had a complete monopoly of banking in Saudi Arabia until the 1950s when the British Bank of the Middle East opened offices in Jeddah, followed by a French bank mainly to cater to the expatriate community of oil workers in the country. Only in 1957 was a second Saudi bank formed known as the Riyadh Bank.

Reluctance by Saudi Arabia to permit commercial banking activity along conventional lines presented monetary flow problems for the country during the 1970s. It also led to the banking system's being a virtual duopoly – consisting of the National Commercial Bank which accounted for 60 percent of total deposits in 1980 and the Riyadh Bank with 20 percent. Banking facilities remained undeveloped with no computerization, checking instruments in infancy stage, and no credit cards were available. In short, banking innovations had been precluded from the country. This lack of facilities and earning opportunities has been said to cause sizeable transfers of funds abroad to earn interest through Bahrain, London and New York. Such a drain of resources would not be a problem if there were no demand for funds in the country. The fact is that with no interest charge, albeit a small service percentage, demand for loans was very high. Credits therefore had to be rationed and the lack of expertise led to the rationing being based on status rather than projects. The enormous increase in demand for imports for consumption and development requirements during the 1970s created a large demand for trade credit.

The undeveloped nature of banking in Saudi Arabia had caused a drain in financial resources and a supply shortage was apparent in the late 1970s. While favored clients could obtain credits at a minimal charge, the majority had to seek funds offshore at high international rates. The application of the Islamic prescription on interest, by limiting growth in the capacity of conventional banks operation and with no alternative avenues for funding, had in fact driven Saudis deeper into the interest net from their offshore borrowings and lending. The Islamic prescription against interest should not mean keeping the financial system undeveloped. The alternative solution is now being offered in the form of Islamic banking and there is a huge scope it can fill in Saudi Arabia to harness funds into profitable, permitted (Halal) ventures and provide depositors with a sharing in the profits. Estimates of Saudi Arabia's unbanked population are between 35 and 60 percent and reveal the potential role that awaits Islamic banking in resource mobilization and utilization for economic development.

Sudan: The Faisal Islamic Bank of Sudan (FIBS) was established on August 18, 1977 and commenced operation on May 10, 1978 with a paid up capital of 2.5 million Sudanese pounds from equity participation by Sudanese authorities and institutions (40%), Saudis (40%) and others (20%). The bank had made such tremendous progress that its capitalization by 1984 stood at 100 million Sudanese pound (of which 60 million were paid-up and 40 million reserves). It is now the largest capitalized bank in Sudan.

FIBS engaged both in trade and investment financing. Within two years of establishment FIBS financed 50 percent of Sudan's exports, particularly of sorghum and oil seeds. It provided import financing of oil, wheat flour, medicines, spare parts and raw materials for industry. Two subsidiary companies were established: the Islamic Insurance Company and the Islamic Trade and Services Company to complement its operation. In keeping with the Islamic economic proposition of helping the small people, FIBS assisted artisans, craftsmen and farmers to purchase tools and equipment at concessionary prices. Its trust financing (Muzarebeh) operations were done in a discriminative manner – charging lower profits on commodities of strategic and social importance such as sugar, rice and flour at less than 1 percent, 5 percent on medicines, and 15 percent on goods with high profit margins. Its profit rates on joint partnership (Musharekat) contracts depended on the actual profit realized from the projects, varying between 7 and 22 percent. Dividend and profit rates had been attractive, with average profit on investment in the early 1980s being 13 to 15 percent. In 1984 the dividend rate declared was 18 percent.

The achievements and workability of FIBS and other Islamic financial institutions was such that it gave sufficient confidence for the Sudanese government, then under the presently exiled President Numeiri, to announce in December 1984 the official ending of conventional- style banking and the start of a fully Islamic banking system.

Turkey: In January 1984, the Turkish government published the guidelines for the establishment of Islamic banks in the country to pave the way for Dar Al-Mal Al-Islami (DMI) Group, the Kuwait Finance House (KFH) and the Al-Barakah Group to open offices. Islamic banks are required to have at least 100 founding shareholders and a minimum capital of 5 billion Turkish Lira. Consequently the first Islamic bank was established in early 1985 – called the Faisal Finance House (FFH) which started operation in April of the same year. The bank had a minimum equity of $200 million of which DMI owns 51 percent and the balance is owned by private Turkish and Arab interests. The Al-Barakah and the Kuwait Finance House are expected to follow DMI later in opening branches in Turkey. Turkey has also entered into an agreement with Libya to set up an Islamic holding company to be based in Istanbul with branches throughout the Middle East. The authorized capital of the company is set at $500 million and its equity participation is open to investors from Muslim countries. The company will concentrate on joint ventures, project financing and trade financing according to principles laid down by Islamic law (Shariat).

United Arab Emirates: The United Arab Emirates (U.A.E.) were among the early founders of Islamic banking with the setting up of a few financial institutions including the Dubai Islamic Bank (1975), the Islamic Investment Company Limited, U.A.E. (1978), and the Islamic Investment Company of the Gulf, Sharjah, U.A.E. of these, the most well-known is the Dubai Islamic Bank (DIB) established in 1975 with a capital of $13.6 million of which Dubai and Kuwaiti rulers owned 20 percent and U.A.E. citizens 80 percent.

DIB, after a slow start due to strong competition from conventional banks, recorded increased financing and investment of $185 million in 1983 compared to $112 million in 1982. The financing of investments was in internal and external trade, real estate and industrial projects, some of which were undertaken in participation with other Islamic banks and companies in the United Arab Emirates and other Persian Gulf Arab States. (Askari et al, 2002)

2.4.3 Islamic Banking outside the Persian Gulf States

Outside the immediate Persian Gulf States of the Middle East, Islamic banking made its greatest progress in Pakistan where the 1979 Decree by president Zia-ul-Haq to Islamize the entire banking sector economy was eventually affected in 1984-85. Conventional banks in Pakistan during that time had to convert all financial activities away from the interest bases. (Sudan also moved in a similar direction under a decree in mid-1982 for the financial system to be Islamized. The Islamic Republic of Iran made a similar decree in 1984.) In other countries, Islamic banking was introduced in the context of free competition and continued coexistence with conventional banks. Bangladesh and Malaysia established their first national Islamic banks in 1983.

Bangladesh: The Islamic Bank of Bangladesh Limited (IBB) was set up by a group of 35 foreign and local investors in March 1983 with an authorized capital of TK500 million and a paid up capital of TK18 million. IBB's shareholders included the Islamic Development Bank, the Jordan Islamic Bank, Kuwait Finance House, Bahrain Islamic Bank and Dubai Islamic Bank with local shareholders being the Baitush Sharaf Foundation, the Bangladesh Islamic Center, the Islamic Economic Research Bureau and the Ibn Sina Trust in Dhaka. IBB made a good start and was able to report profits at the end of its very first year of operation. It declared a profit sharing of 9.89 percent on savings accounts, and offered between 11.31 and 14.13 percent on term deposits or investment accounts compared to 4.95 percent it offered on short notice deposit accounts early in the year. By the end of the financial year, IBB was able to attract deposits amounting to TK630 million. The bank financed operations in foreign trade, agricultural, commercial and real estate projects, including 85 garment manufacturing firms, 17 textile mills, as well as oil tankers, ship-building and ice factories. From its operations IBB earned an investment income of TK40.34 million.

Europe: Europe's first Islamic investment company was established in Luxembourg in 1980, called the Islamic Banking System International Holding (IBS). Its authorized capital was $100 million. Of an issued capital of $34.8 million, $26 million was paid-up to which Al-barakah contributed 22 percent, the Al-Rajhi company of Saudi Arabia 17 percent, Kuwait Finance House 13 percent, and the remaining balance was taken up by interests in Abu Dhabi and Qatar. In October 1983 subscribed capital stood at $35 million. Operations consisted mainly of giving loans and risk capital to affiliates and sharing in their results. IBS recorded increases in total assets from $13.3 million in 1982 to $16.7 million in 1983 for its IBS Holding Company and from $14.6 million to $41.8 million for IBS Finance, both being wings of IBS's operation. Deposits with IBS also grew from $27 million to $57 million. Following some changes in the banking laws of Luxembourg in 1985, IBS changed its name to Islamic Finance House Universal Holding in order not to be subjected to Luxembourg's banking requirements.

IBS's subsidiary in Denmark, called the Islamic Bank International of Denmark, was established in April 1983 with a capitalization of 50 million Danish Kroners. It was the first Islamic commercial bank established in Europe and has been returning profits since its establishment. In 1984 the total deposits with the bank increased by more than 40 percent and over 90 percent of the total deposits came from depositors residing outside Denmark. Another subsidiary of IBS is the Liechtenstein-based IBS Finance Company with total assets of $45.6 million.

In the 1984-85 period, IBS encountered problems relating to advances given to its affiliates amounting to $21 million. It had to provide provisions for write-offs and non-payments of $3.3 million which, in percentage terms, amounted to 15-20 percent bad debts. As one of the measures undertaken to overcome the problem, funds from small investors were marked for relatively risk-free Murabahah (cost-plus pricing) and Al-Ijarah (leasing) operations. Larger sums of $1 million and over were treated separately with a more attractive profit potential although involving a higher risk profile. To avoid currency exchange risk, deposits and returns are denominated in the same specified currencies. In spite of the tribulations, IBS declared a return of 6.06 percent for dollar advances of one year in 1984 as compared to 5.30 percent in 1983. However, this meant that shareholders were not paid any dividends on their investment for the second year running, the last dividend of 10 percent was paid in 1982.

There have been a few other Islamic financial institutions established in Europe for which little information is available. Among these are the Al-Rajhi Company for Islamic Investments, London (1980), the Islamic Finance House Public Limited, London (1981), which is a subsidiary of IBS, the Islamic Investment Company of U.K., London (1982) with a 51 percent equity holding by DMI, and the DMI Office in Geneva (1981) complementing the one in the Bahamas (1981).

Pakistan: The progress of Islamic banking in Pakistan differed from that of the Persian Gulf states, except for Iran and Sudan. The Islamization of the banking system is State ordered, similar to the cases in Iran and Sudan. Under a 1979 Decree by President Zia-ul-Haq, the entire banking system was to be Islamised over a period of three years. It actually took five years to convert the conventional system into an Islamic banking system. In the initial stage, conventional banks established interest-free departments and counters with all five nationalized banks and their 6600 branches opening profit and loss sharing (PLS) counters. By mid-1981 the PLS counters were successful in attracting Rupees 3 billion in deposits. Dividends declared were attractive, ranging from 10.75 to 15.25 percent on deposits ranging from 6 months to 5 years.

The Islamisation process of the financial system began with the conversion of the National Investment Trust (NIT) an open mutual fund established by the Government in 1962 for attracting deposits for investment in the corporate sector. NIT was basically a unit trust with its more than 75,000 unit holders in effect being shareholders in the corporate sector. NIT was converted to an interest free institution by mid-1979.

NIT's conversion was followed by that of the Investment Corporation of Pakistan (ICP) which was established in 1966 to help the people to invest in shares in the capital market. Following the conversion of all mutual funds to an interest free basis in 1979, in 1980 the ICP's investors scheme was introduced and in 1981 debenture financing was replaced by the Participation Term Certificates (PTCs) as proposed by the Council of Islamic Ideology. A new investment institution, the Bankers Equity Limited was established in 1979 and its operation was converted to the Muzarebeh (limited partnership) concept in 1981 as a Muzarebeh company under the Modaraba Ordinance introduced in 1980. Its objective was to promote private sector investment in medium and larger industries and to develop the capital market using interest free instruments and facilities. The Bankers Equity Company had an authorized capital of Rs 1billion of which Rs 250 million had been paid up by the State Bank and the five nationalized commercial banks.

A third institution to be converted to the Islamic basis of operation was the House Building Finance Corporation (HBFC) established in 1952 to provide financial assistance for house building in urban areas. Its conversion to an Islamic basis used the principle of Musharekat or joint partnership in which case the bank would buy the house being constructed and then rent the property to the prospective buyer whose monthly rental payments formed the installments towards the cost of the house. The house would eventually be transferred to the renter, after a period of payments sufficient to cover the cost of the house. This mode of financing house purchase has since been adopted by the nationalized banks, except that the banks seek a 75 percent sharing in the rental income compared to only 50 percent by HBFC.

The Small Business Finance Corporation (SBFC),was established in 1972 to provide finance for small entrepreneurs, craftsmen and traders, and was the next to be converted using two schemes. One was by providing equipment through leasing or through cost-plus pricing (Murabahah) sales; the other was based on profit participation with the entrepreneur.

Pakistan's Islamisation of the rest of the financial system was made absolute, beginning January 1, 1985 under two Ordinances – the Banking Tribunal Ordinance (1984), and the Banking and Financial Services (Amendment of Laws) Ordinance (1984). The ordinances laid down the permissible modes of financing to be adopted by financial institutions, classifying them into three categories; lending, trade and investment modes of financing.

South Africa: Investments conducted on Islamic law (Shariat) principles gained momentum among the one million Muslims in South Africa. The major financial institution is Jaame Limited established in August 1980 and based in Fordsburg. It had an authorized and issued capital of R 25000 at its establishment and had since increased its capital to R 1.7 million in 1984. The main objective was to finance short, medium and long term projects along Islamic lines. In 1984, project investments on a profit participation basis amounted to R 97298. Jaame Limited had five subsidiaries operating in curtain accessories, drugs and surgical equipment, manufactures of motor spare parts and accessories, plastics and properties. Jaame paid out a profit participation rate of 11.1 percent in early 1985. One of its subsidiaries, Wonder Accessories Limited paid a dividend rate of 22.5 percent in 1985 compared to 18 percent in 1984.

The other major center for Islamic finance is Cape Town, where the Shura Trust was formed in 1981 to fund various welfare and community projects of the Majlis Shura al-Islami including investments, welfare projects, schools, libraries and mosques. The main Islamic financial institution of Shura Trust is Ash-Shura

Limited a public company formed in 1982 with an authorized capital of R 100000. It functioned as a broker and a unit trust purchasing corporate shares for itself and for its members. It had yet to declare its first dividend in 1983. (Muslehuddim.M, 2003)

2.5 Unique Features of Islamic Banks

The principal restriction under which the Islamic financial system must work is the injunction against interest. However, it is important to note that what is forbidden by Islamic law is the fixed or predetermined return on financial transactions, and not an uncertain rate of return represented by profits. For this reason the modern concept of Islamic banking has developed on the basis of profit sharing. In the last few decades a variety of models of Islamic banking have been proposed, but in general the operations of a typical system would have the following features.

2.5.1 Sources of Funds

Besides its own capital and equity, the main sources of funds for an Islamic bank would be two forms of deposits-transactions and investment deposits. Transaction deposits are directly related to 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. Investment deposits constitute the principal source of funds for banks, and they resemble more closely 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 profit, or loss, 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 share, or distribution, parameter has to be agreed on in advance of the transaction between the bank and the depositor and cannot be altered during the life of the contract, except by mutual consent.(Abdul Gafoor.A.L.M ,1995)

2.5.2 Asset Acquisition

The bank can acquire profit-sharing assets via two principle modes of transactions: Muzarebeh and Musharekat. Under the provisions of the first mode, surplus funds are made available to the entrepreneur to be invested in a productive enterprise in return for a predetermined share of the profits earned.(Abbas Mirakhor, 2003) 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. In Musharekat, on the other hand, there is more than a single contributor of funds. All parties invest in varying proportions, and the profits (or losses) are shared strictly in relation to their respective capital contribution. This financing method corresponds to an equity market in which shares can be acquired by the public, banks, and even the central bank and the government. Traditionally, Muzarebeh has been employed in investment projects with short gestation periods and in trade and commerce, whereas Musharekat is used in long-term investment projects. These two modes have their historical counterparts in farming (Muzarebeh) and in orchard keeping (Musaqat), where the harvest is shared between the partners based on pre specified shares.(Schacht. J ,1964)

In transactions where profit sharing is not applicable, other modes of financing can be employed, which include the following:

I. Gharzolhasaneh (beneficence loan). These are zero-return loans that the Quran exhorts Muslims to make available to those who need them. Financial organizations that provide these loans are permitted to charge the borrower a service charge to cover administrative costs of handling the loan as long as the charge is not related to the amount or the time period of the loan, and represents solely the cost of administering the loan.

2. Bai' Mua'jjal (deferred-payment sales). This mode allows the sale of a product on the basis of deferred payment in installments or in a lump-sum payment. The price of the product is agreed on between the buyer and the seller at the time of the sale and cannot include any charges for deferring payments.

3. Salaf (purchase with deferred delivery). In this transaction the buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date. This transaction is limited to products whose quality and quantity can be fully specified at the time the contract is made, that is, agricultural and manufactured products.

4. Ijareh (leasing). In this transaction, a person leases a particular product for a specific sum and a specific period of time. He can also negotiate for lease-purchase of the product, where each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.

5. Joaleh (service charge). This is a transaction in which one party undertakes to pay another a specified sum of money as a fee for rendering a specific service in accordance with the terms of the contract negotiated between the two parties. This mode facilitates consultation, fund placements, and trust activities.(Homoud. S, 1985)

The above list is by no means exhaustive. Under Islamic law the freedom of contracts provide the parties with a flexibility that makes possible a virtually open-ended variety of forms of financial transactions and instruments. There is nothing to constrain the system from creating any contractual form as long as the contract does not include interest and both parties are fully informed of the details of the contract.

The replacement of an interest-based banking system by an alternative system that relies primarily on profit-sharing arrangements raises a number of fundamental theoretical and practical questions. Among the most important of these are: First, how will an Islamic banking system function? Second, what would be the effects of adopting such a system on the economy and, in particular, on macroeconomic variables like savings and investment? And third, what role, if any, would monetary policy play in the Islamic system?

Research on these types of questions is still in its very early stages. Nevertheless, in recent years there have been a number of studies that have attempted to conceptualize the basic ideas underlying Islamic banking, as well as the likely consequences that would follow from the institution of this system.(Mohsin.S.Khan and Abbas Mirakhor, 2002) Taking the view that the reliance on profit-sharing arrangements makes the Islamic system akin to an equity-based system, relatively straightforward theoretical models have been developed analyzing the workings of the system. In these models, depositors are treated as shareholders (as in a mutual fund or investment trust, e.g.) and banks provide no guarantee on the rate of return or the nominal value of shares. Symmetrically, banks themselves become partners with the borrowers and accordingly share in the returns obtained from the borrowed funds. An interesting result that emerges from such models is that the Islamic system may be better suited to adjust to shocks that can lead to banking crises than an interest-based banking system. In an equity-based system, shocks to the asset positions of banks are immediately absorbed by changes in the nominal value of shares (deposits) held by the public in banks. Therefore, the real values of assets and liabilities would be equal at all points in time. In the conventional banking system, since the nominal value of deposits is guaranteed by the bank, an adverse shock to assets of the bank can create a divergence between real assets and real liabilities ,leading possibly to a negative net worth for the bankand it is not clear how the disequilibrium would be corrected nor how long the process of adjustment would take.(Mohsen.S.Khan, 1998)

The elimination of a risk-free asset with a positive predetermined return is expected to have significant consequences for savings, investment, financial development, and so forth, as well as for the conduct of monetary policy. For example, there is a presumption that the removal of a fixed interest rate increases uncertainty, which in turn would reduce savings and make lenders worse off.(Zubair Iqbal and Abbas Mirakhor, 1987) However, this will depend on the behavior of financial rates of return in the economy. Models that allow for variations in rates of return, as well as in risk, derive the basic condition that has to be met in order for savings to decrease as risk increases. This condition requires that the rate of return on the asset must not be higher after the increase in uncertainty than it was before if savings are to fall. If the rate of return also increases as risk increases, then savings would be unchanged or may, in fact, rise. Serious issues also arise in the area of investment as the adoption of a profit-sharing arrangement between the lender, that is, the bank, and investor may raise monitoring costs and discourage investment. To avoid this adverse effect and moral hazard issues that arise when the lender and investor have different information on the profits from the investment requires the implementation of a legal and institutional framework that facilitates appropriate contracts. The form of these contracts, and the mechanism for enforcing them, still need to be spelled out. Insofar as monetary policy is concerned, the central bank would lose the ability to directly set financial rates of return in an Islamic banking system. However, theoretical work has shown that indirect methods through control of credit extended by banks, reserve requirement changes, and varying of profit-sharing ratios can achieve results for monetary policy similar to those in a conventional interest-based economy.(Abbas Mirakhor and Iqbal Zaidi, 1988)

2.6 History of Islamic Banking in Iran

The process of Islamization of the banking system in Iran has gone through three distinct phases. In the first phase (1979-82), the banking system was nationalized, restructured, and reorganized in order to remove the weaknesses of the inherited system. External and internal developments in this phase did not allow the policymakers to develop a coherent plan for Islamization of the banking system, although various piecemeal attempts were made toward this objective.

The second phase began in 1982 and lasted until 1986. In this phase a legislative and administrative quantum leap was made in adopting and implementing a clearly articulated model of Islamic banking. The Law for *Reba-Free* Banking was passed in August 1983, giving a very short deadline of one year for the banks to convert their deposits to be in line with Islamic law and 3 years for their total operations from the date of the passage of the law. During this phase the central bank was implicitly envisioned as a quasi-independent economic institution similar to that of most Western banking systems, with a considerable degree of autonomy from the rest of the government. As in other countries, the central bank exercised extensive control over the operation of individual banks.

The third and current phase, which began in 1986, defines a role for the banking system different from the earlier phases, in that the system is now expected to be an integral part of the Islamic government and, thus, a direct instrument of its policies. This development is a direct result of the political debate within Iran surrounding the proper role of the government in an Islamic economy. This debate culminated in a recent ruling by Imam Khomeini, which confirmed a highly activist role for the central government in shaping the structure of the Iranian economy and legitimized a trend in the interventionist posture of the government vis-a-vis the economy. This ruling also indirectly affirmed the use of the banking system as an instrument for promoting social and economic development.(Vahe Petrossian,1988)

Much of the trend in Islamic banking in Iran has been influenced by factors that have their roots in the prerevolutionary economic structure, as well as post-revolutionary external and internal political developments. The post-revolution economy had inherited a host of difficult economic problems. Before the revolution, the Iranian economy had become highly dependent on oil revenues as well as on the importation of raw materials, intermediate goods, and food. The industrial sector was organized without due attention paid to efficiency or comparative advantage and with very weak forward and backward linkages to the rest of the economy. The agricultural sector, which was producing surplus commodities until the late 1960s, began to contract, and there was a massive migration of farmers into the cities. Poor economic planning, the influx of enormous oil revenues, and a rapid increase in government expenditures stimulated the growth of the private sector enjoying import controls, exclusive licenses, low-interest loans, and low taxes on profits. The result of these policies was that at the time of the revolution Iran had a private sector that had a perception of its role in the economy quite different from that envisioned by the Islamic leadership of the country.(Homa Katouzian,1988)

The revolution brought with it a host of economic problems including, interalia, massive capital flight, which almost led to the collapse of the banking and financial system. The problems began to multiply for the economy at a rapid pace as the revolution took root. The economy, already vulnerable to internal and external shocks, faced the freezing of foreign assets, economic sanctions, interruptions in production, the influx of nearly 2 million Afghan refugees, the war with Iraq, and drastic reductions in oil revenues. Concurrently, the constitution of the Islamic Republic specified objectives for the economy to be pursued-such as income redistribution, self-sufficiency in production, strengthening of the agriculture sector, creation of an active cooperative sector in the economy, and reduced reliance on oil revenues-all of which required fundamental restructuring of the society's economic behavior and institutions. The fall in oil revenues, plus the political objective of non-reliance on external financial resources, inevitably meant that the banking system would be relied on to play role far broader than that of pure intermediation.(Sohrab Behdad,1998)

The banking sector has been used as an instrument of restructuring the economy-away from services and consumption toward production in four ways. First, credit to the service sector, which constituted some 55% of the GDP, has been drastically reduced to halt its expansion in the short run and to curtail its size in the medium term. This policy went into effect during the second phase and has been continued with a varying degree of rigor in the later phase. Second, bank credit has been used to encourage the growth of the agriculture sector by using all available modes of Islamic finance to help farmers to improve and expand production. Coupled with substantial government subsidies for seed, fertilizer, machinery, and crop insurance, the credit policy of the banking system is aimed at reviving the agricultural sector. This policy was initiated during the first phase and strengthened in the later phases. Third, Islamic banking has been used to create incentives for the development of a cooperative sector spanning agriculture, industry, and trade. Cooperatives are given priority in credit allocation and in direct investment as well as in Musharekat financing by the banking sector. At present, the Central

Bank has devised a plan under which it will provide nearly all the needed finance, in the form of venture capital, for "innovative" industrial projects prepared by cooperatives. Priority for complete financing by the banking system is given to cooperative ventures with projects promising "domestication" of imported technology. Fourth, the banking system, in partnership with the government, has undertaken to finance large industrial projects and investments in social overhead capital.

The pattern of consumption and production in the economy has been affected by the banking system, not only through the reduction of credit to the service sector and increased credit availability to the agriculture sector but also through severe curtailment of credit to the producers and importers of luxury goods. Simultaneously, it is expanding credit for the production and importation of necessary and intermediate products. The banking system also has been used as an instrument of income redistribution through the provision of Gharzolhasaneh (beneficence loan) loans for the needy, financing the building of low-income housing, and provision of financing for small scale agribusinesses and industrial cooperatives, often without stringent collateral requirements. Additionally, the banking system has financed government deficits, which obviously have distributional impacts. It is clear that with reduction of oil revenues, the banking system has been a major source of finance for achieving many of the social and economic goals of the Islamic revolution. This active role of the banking system, moreover, is not likely to lose its importance in the medium term.(Abbas Mirakhor,1999)

Given the extraordinary circumstances in which the Iranian economy has found itself since the revolution, the performance of Islamic banking since its implementation has been remarkably smooth.

2.7 Islamic Banking Services in Iran

Islamic banks in Iran have many services as follow:

2.7.1 Facilities

1. **Gharzolhasaneh (Beneficence Loan)**: Syllabified as Ghar.zol.ha.sa.ne according to its Farsi pronunciation, and alternatively spelt out as Qard-al-hassanah, Ghardulhassanah,, etc.,

Gharzolhasaneh is: 1. In terms of resource mobilization , a) an interest-free savings account, the holder of which may gain rewards as a result of the bank prize draws in cases where the minimum balance exceeds IRR 50000 over the contractual period. Throughout this report, savings accounts refer to

Gharzolhaaneh saving accounts; and b) the current account in the Islamic Banking system of Iran. The account is interest-free and, throughout the report, current accounts refer to Gharzolhasaneh current accounts. 2. In terms of the application of funds, an obligatory contract whereby the bank, (as lender) lends a specified sum to the applicant (the borrower) under specified terms. The contract covers the costs of marriage, house repair, housing, medical treatment and education.

2. Mozarebeh (Profit Loss Sharing): Syllabified as Mo.za.re.be according to its Farsi pronunciation, and alternatively spelt out as Modharabah, Mudharabah, etc., Mozarebe is a contract whereby one of the parties (the bank) provides funds in cash, indicating that the other party (the applicant, also known as the agent) is to conduct business with the funds, with both parties sharing the profit.

3. Salaf (Forward Sale): Syllabified as sa.laf according to its Farsi pronunciation, with letters 'a' pronounced as 'a 'in 'act', Salaf, or forward deals are advance cash purchases of products (industrial and mining as well as agricultural) at a predetermined price, when, during the process of production, the producer feels a financial constraint on the part of his working capital needs. Banks are authorized to sign such deals only at the request of a producer.

4. Jealeh (Service Charge): Syllabified as Je.a.le according to its Farsi pronunciation, and alternatively spelt out as Jo'aalah, Ju'alah, etc., Jealeh in general refers to the undertaking of one party (the contracting party) to pay a specified amount to the other party for rendering a specific service in accordance with the terms and conditions of the contract. Acting as an agent, or as the contracting party if required, banks may conclude a Jealeh contract, which is one of the short term facilities granted for the expansion of production, commercial, and service activities for the purpose of providing facilities to develop businesses in the fields of production, commerce and service.

5. Hire Purchase (Leasing Conditional on Ownership): Hiring agreement incorporates a condition that at the end of the hiring period, the hiring party will take up ownership of the exact hired article. The agreement involves three stages: 1. purchase, 2. hire, 3. sale and/or transfer.

6. Installment Sale: Installment sale is a contact which transfers the ownership of an item that can be raw materials, machinery and housing to another party, at a known price, in such a manner that all or part of the price of the said item shall be received in equal or unequal installments at fixed maturity, or maturity dates.

7. Civil Partnership: Introduced for the first time by the Islamic banking system of Iran, civil partnership is defined as the mixing of the capital -in cash or kind-of a partner or partners, with the capital –in cash or kind- of the bank, on a joint –ownership basis, for the performance of a specific job in the field of production, trade and services, for a limited duration, and with the intention of making a profit on the basis of a agreement.

2.7.2 Current Gharzolhasaneh Deposits

1. Current Gharzolhasaneh Deposit Account for Individual: This is a demand deposit, which enables individuals to withdraw their funds from their accounts, totally or partially to pay another by cheque.

2. Current Gharzolhasaneh Deposit Account for Governmental Bodies: By the order of Ministry of Economic Affairs and Finances and according to the provisions of article 76 of the State Act, governmental bodies including Ministries, governmental / governmental – affiliated corporations, governmental companies, Municipalities and also the corporations of which more than half of their capital is owned by the Ministries, governmental / governmental – affiliated corporations and governmental companies or municipalities can open a governmental account with banks.

3. Current Gharzolhasaneh Deposit Account for Governmental Companies: A governmental company is a specific organizational unit which is established as a company by law or is nationalized or confiscated by law or by a verdict issued by a competent court, and it is identified as a governmental company of which more than 50% of its capital is owned by the government.

4. Current Gharzolhasaneh Deposit Account for Legal Entities: It is a demand deposit, which enables legal entities to withdraw their funds out of their account totally or partially or to pay others by cheque.

5. Current Gharzolhasaneh Deposit Account for the Companies about to Be Established: Public or private joint stock companies about to be established (not registered yet) can open a current Gharzolhasaneh deposit account.

6. Current Gharzolhasaneh Deposit for Foreigners: Foreigners, residents of Iran, or abroad can a open current Gharzalhasaneh deposit account .

7. Golden Current Gharzolhasaneh Deposit Account: This is a kind of current Gharzolhasaneh Deposit account. The depositors of Bank ATM accounts, if qualified, can open such an account with Bank branches and benefit from many services including withdrawing cash, depositing, transferring funds, etc, in all branches connected to the Golden current account network. The checkbook which is delivered to the opener of this account is named Golden cheque.

8. Joint Current Gharzolhasaneh Deposit Account: Opening a joint current Gharzolhasaneh deposit account (by two or more people) is possible.

2.7.3 Gharzolhasaneh Savings Account

1. Circulating Gharzolhasaneh Deposit Account: This is very similar to the ordinary Gharzolhasaneh savings account, except that there is an advantage of being able to deposit to, or withdraw from this account through any branch of the bank across the country.

2. The Gharzolhasaneh Saving for the Youth: To encourage the young generation of the country to save and finance their future's needs, the bank opens such accounts.

3. The circulating Gharzolhasaneh Saving Accounts: The sums which the customers deposit to the bank in order to get the benefit of worldly merits (Prize-drawing) in addition to spiritual ones.

4. The Consumed Gharzolhasabeh Saving Account: This is a kind of account in which the deposited sums by individual and legal entities shall be granted to the individuals or public utility institutions in the form of Gharzolhasaneh at the depositor's discretion.

5. The Joint Gharzolhasaneh Saving Account: The applicant can open this interest free account jointly with one or more person.

2.7.4 Guarantee

1. Advance Payment Guarantee: A guarantee issued at the request of contractor in favor of an employer to assure repayment of the down-execution of the contractor's commitments ion.

2. Bid Bond Guarantee: A guarantee issued at the request of a bidder who is willing to participate in a bid announced through official gazettes by legal entities. This guarantee is extendable for short periods of time.

3. Customs Guarantee: A guarantee issued at the request of an importer in favor of Iran Customs to secure the clearing of imported goods (in case the importer is not capable of remitting his customs duties and trade profits). This guarantee will be issued for clients who have issued their L/C in the L/G issuing branch, if any.

4. Performance Bond Guarantee: A guarantee issued to secure the good performance of the contractor's obligations under the relevant contract. This guarantee is also issued when the bidder wins the bid.

5. Retention Guarantee: A guarantee issued at the request of contractor to secure repayment of the retention money held by the employer during different phases of the project, when the project is finalized (at the time of provisional delivery clips).

2.7.5 Payment Orders and Bank Cheque

1. Bank Cheque: To prevent the transfer of cash physically and to facilitate customer's cash transfer, branches issue cheques. At the customer's request, the bank issues enchasing cheques which are tested and guaranteed. The bank guarantees the payment of cheque amounts.

2. Collection of Bill of Exchange: Bank Bill of Exchange refers to cheques, promissory notes or drafts which are issued by branches located in other towns. For the purpose of their collection, these notes are submitted to the Bank.

3. Colleting Customers Cheques: Current account holders can have cheques cashed by going to a branch which is not necessarily the branch where he /she has an account.

4. Inter Bank Cheque: This is a kind of cheque which is issued at the customer's request and by a bank in the order of the banks branches, which are members of "inter bank cheque's network", to settle in a particular account (except long-term deposit) throughout a city.

5. Iran Cheque:The Iran Cheque and is a type of traveler's cheque issued by the Bank. Iran Cheques are issued in the block of IRR 500000 and IRR 1000000 . The advantages of this cheque includes the avoidance of transportation of cash by customers, the ease of transactions and the prevention of possible risks in line with cash transportation.

6. Payment Orders: To transfer the funds to all branches throughout the country, at customer's request the payments are ordered, through telephone, fax or mail without delay.

7. Travel Cheque: Travel Cheque is a kind of travelers' cheques issued by the Bank. Travel Cheques are issued in blocks of IRR 500000, IRR 1000000, IRR 2000000 , and IRR 5000000. The advantages of this cheque includes avoidance of transportation of cash by customers, the ease of transactions and the prevention of possible risks in line with cash transportation.

2.7.6 Special Services

1. Auto-Info-Dispatching System: One of the principal functions of organizations is to provide required information to customers; most of time as well as energy of employees and officials of organizations are engaged in providing information for their customers and also answering questions raised by them while using the new means of communication we can provide the necessary information, with customers bearing of the least expenditure and in the soonest possible time.

2. Collection of Bills of Utility Services: All branches of the Bank are responsible for the collection of water, gas, electricity and telephone bills.

3. Collection of Fast Collectable Cheque: Acceptance and collection of account holders transfer cheques in other branches. Should a customer of bank, due to the long distance from his/her domicile to the designated branch, not be able to approach the branch to cash the cheques at his/her disposal, he/she may refer to the nearest branch of bank to cash them, requesting the branch to transfer the cheque amounts after being collected by said branch to his/her account held with any other branches.

4. Faxed cheque Collection: Collection of all cheques including intra checks which fall within the obligations of bank, through facsimile at the earliest possible time. Execution of said service enables the customers' checks to be collected within the same banking day.

5. Leasehold Safe Boxes: Leasehold Safe Box which is considered to be one of the necessaries of any citizens, has attracted esteemed customers of bank as well. Holders of securities and valuable goods have always worried about the rubbery of valuables. During economic boom, in which people show their tendency to invest in various fields, this necessity appears more obvious and most people prefer to keep their securities and valuables in a safe place. Backed by their valuable belongings, customers can utilize the bank's resource for investment. In a period of economic depression, which is always accompanied by decrease in the annual income, fear of the valuable goods being stolen strengthens and a safe place to maintain these things with less accommodation is required.

6. Mobile Banking: Mobile Banking is a system in which customers can receive their stock turnover as well as the leaving balance of their account on the monitor of their cellar phones.

7. Telephone Bank: Establishment of the Telephone Bank is aimed at the rapid accessibility of customers to current, savings, short-term and ATM short-term accounts through telephone connections.

8. System of Question and Answer: Since in any organization answering clients' questions and providing answers the bank is ready to receive any criticism and suggestion of the esteemed customers and other countrymen 24 hours a day.

2.7.7 Term Deposits Accounts

1. 1 to 5 Years Long-Term Investment Deposit Account for Individuals and Legal Entities: In a long-term investment deposit, depositors hold some amount in his/her account for 1 to 5 years. The profit rate is calculated according to the invest period (on a daily basis) on account and is payable to depositors.

2. Aber Bank Short-Term Investment Deposit Account: To facilitate modern banking services, the bank uses a magnetic card for the first time in Iran and present Aber Bank Cards (ATM Card) to customers instead of bank accounts. ATM cards operate through modern computerized systems by the name of Automated Teller Machines installed in some bank branches and P.O.S in all. The minimum amount to open an ATM account is IRR 100000. All armed forces are exempt from this deposit. Companies, institutions and military units can pay their personnel's salaries through a bank's ATM by concluding a contract. Some advantages are : Clients can utilize the ATM system around the clock to obtain every related service such as the payment of utility bills, the transfer of funds, and cash the withdrawal a deposit of cash .

3. Future Security Investment Deposit Account for 5 and 10 Years: Future security deposits, in ten-and five-year variants, finance employment, housing, purchase of automobiles, higher education for the holders children, preparation of a dowry and enhancement of the income at the time of retirement.

4. Long-Term Investment Deposit: In a long-term investment deposit, depositors hold some amount in his/her account for 1 to 5 years. The profit rate is calculated according to the investment period (on daily basis) on account and is payable to depositors. Types of Long-term investment deposit: Long-term investment deposit account for 1 to 5 years for individuals and legal entities; pension investment deposit accounts; and future security investment deposit accounts for 5 and 10 years.

5. Pension Investment Deposit: Pension investment deposit is a kind of long-term deposit account. Pension deposit requires applicants to deposit monthly, certain identical amounts. The account holders, upon the termination of a three-or five-year period from the commencement of the deposit and on a monthly basis, receive life-long 50 or 100% of the total amount deposited, depending on the period over which the deposit is held.

6. Special Short-term Investment Deposit Account: This is a kind of short-term investment deposit in which the investor deposits an amount in bank for 6 months and during this period keeps it fixed.

2.7.8 Term Investment Deposits

1. Short-Term Investment Deposit Account for the Individual and Legal Entities: In this kind of deposit, the depositor can pay into or withdraw from the account disregarding the duration. Profit is accrued on this account based on a minimum balance of the account and at provisional rates on a daily basis. (Musavian,S.A, 2004)

2.8 Summary

Islamic finance is an ethical, indigenous and equitable mode of finance, which derives its principles from the Quran (the revealed book of Muslims) and tradition of the Prophet Mohammad. Shariat law (Islamic law), which is based on the Quran and Sonnat, governs Islamic finance.

This is a trend which is broadening the ownership base, creating more stakeholders and thereby bringing the hope of stability to more than 1.3 billion Muslims spread across the world.

Islamic finance, as a concept, is based on themes of Community Banking, Ethical and Socially Responsible Investments and Affinity Marketing. These themes themselves are based on core ideas, which include individual responsibility, reliance on market mechanisms, commitment to economic and social justice and mandatory care for the environment. These guidelines also include prohibitions from investing in areas such as Defence and Armaments, Casinos, Breweries and other areas which are considered to be value destroyers.

In Islamic finance, scholars say that everything is allowed except that which has been specifically forbidden. In essence, the believing Muslim's view of economics is based on man's obligation to organize his affairs in accordance to the will of God as his representative and vice regent on earth. The goal is not equality but an avoidance of gross inequality along with an injunction that wealth should not become "a commodity between the rich among you". Islamic Finance is firmly embedded in the commercial, real, value-producing economy.

The desire of enlightened Muslims to seek the moral equivalent of Modern Capitalism goes back to Egypt in the early 1970s. The pioneering effort in Egypt took the form of a savings bank based on profit-sharing in the town of

Mit Ghamr. The Islamic Development Bank (IDB) was established in 1975 by the Organization of Islamic Conference (OIC), but it was primarily an intergovernmental bank aimed at providing funds for development projects in member countries. The IDB now extends to the private sector corporations for project and trade finance facilities.

In the mid-1970s, Islamic banks came into existence in Saudi Arabia and the United Arab Emirates. Since then, Islamic financial institutions have emerged in a large number of Muslim countries including Iran, Kuwait, Bahrain, Qatar, Turkey, Pakistan, Indonesia and a belt of other IDB member countries. These institutions have taken the form of commercial banks, investment banks, investment and finance companies, insurance companies, etc.

Table 2.1

LIST OF ISLAMIC BANKS AND FINANCIAL INSTITUTIONS

Name of Institution	Year established
Rural Savings Bank, Mit Ghamr, Egypt	1963
Pilgrims Management and Funds Board, Malaysia	1963
Nasser Social Bank, Cairo, Egypt	1972
Philippines Amanah Bank, Zamboanga City	1973
Islamic Development Bank, Jeddah, Saudi Arabia	1975
Dubai Islamic Bank, U.A.E.	1975
First Muslim Interest Free Business, Johannesburg, South Africa	1976
Kuwait Finance House	1977
Faisal Islamic Bank of Sudan, Khartoum	1977
Faisal Islamic Bank of Egypt, Cairo	1977

Islamic Investment Co. Ltd., Nassau	1977
Islamic Investment Co. Ltd., U.A.E.	1978
Jordan Islamic Bank for Finance and Investment, Amman, Jordan	1978
Sepah Islamic Bank of Iran, Tehran	1979
Abu Dhabi Islamic Bank	1979
Bahrain Islamic Bank, Manama	1979
Bahrain Islamic Investment Company	1980
Islamic Banking System (IBS) International Holding (Islamic Finance House Universal Holding), Luxembourg	1980
National Investment Trust (1962), Pakistan	1980
House Building Finance Corporation (1952), Pakistan	1980
Investment Corporation of Pakistan (1966)	1980
Small Business Finance Corporation (1972), Pakistan	1980
Bankers Equity Limited, Pakistan	1980

Jaame Limited, Fordsburg, South Africa	1980
International Islamic Bank for Investment and Development, Egypt	1980
Al-Rajhi Company for Islamic Investments, London	1980
Islamic Finance House, Bahamas	1981
Islamic Investment House, Amman	1981
Shura Trust, Cape Town, South Africa	1981
Islamic Finance House Public Ltd., London	1981
Dar al-Mal al-Islami Bahamas and Geneva	1981
Faisal Islamic Bank of Kibris, Cyprus	1982
Islamic Investment Co. of U.K., London	1982
Massraf Faisal al-Islami, Bahrain	1982
Islamic Bank International of Denmark	1983
Islamic Bank Bangaldesh Ltd.	1983

Bank Islam Malaysia Berhad, Kuala Lumpur	1983
All banks in Iran, namely: Bank Melli, Bank Saderat, Bank Tejarat, Bank Mellat, Bank Sepah, The Agricultural Bank, Bank of Industry & Mines, Housing Bank and the cooperative Bank	1984
Faisal Finance House, Turkey	1985
Al-Rajhi Banking Investment Corporation, Saudi Arabia (to be reincorporated)	1985-86

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