CHAPTER-3

Bank Reorganization: An Islamic Way

Introduction

The elimination of interest is the core of Islamic financial system. Not only Islam but in all the major religions of the world interest has been held as contempt. Besides Islam, Hinduism, Judaism and Christianity all have tried to restrict the practices of interest in some way or the other. In Islam the ruling against interest (riba) is very clear and final. For Christian interest was highly condemned till beginning of the industrial revolution and Judaism permitted interest extract only from the non-Jews. While in Hinduism Manu’s laws tried to restrict interest practices.

Several of the ancient philosophers like Plato, Aristotle, the two Catos, Cicero, Seneca and Plutarch, for various reasons, were against the practices of usury. St. Thomas Aquinas was of the view that money was invented chiefly for the purpose of exchange and that its principal use was its consumption and annihilation where by it is sunk in exchange. Hence it was unlawful to make payment for the use of money lent. Zamir Iqbal, a research officer at the World Bank, points out that prohibition of interest is not limited to Islam but is also shared by Judaism and Christianity and the first interest free bank in

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1 For Islamic view on interest (riba), please refer to the Quran, chapters: 30:39, 4:161, 3:130-2, and 2:275-81.


documented history *Agibi Bank* was established in pre-Islamic period circa 700 B.C. in Babylonia. This bank functioned exclusively on an equity basis.¹

In the 8th century, Charlemagne made usury a criminal offence. And it was only in the 16th century that interest became prevalent in the Christian world and that too when Popes started financing kings and other business men, even during that period multiple agreements were made among several parties to circumvent the existing laws against the interest. It is quite interesting to explore that in spite of prohibition of usury (interest) in all the major religions how the interest or usury has become so indispensable to the present world financial system. It has become so inseparable part of the system that financial system without interest or banking without interest even among the experts could be held as the utopia. In the following paragraphs we shall try to briefly visualize how precious metals deposited with goldsmiths developed to bank money and became a source of earning interest.

The present interest-based banking system, which now forms the foundation of the monetary system in every modern nation, as we have seen in the first chapter, originated from the practices of goldsmiths who established the first modern bank in Europe. These goldsmiths initially offered their services to those who wished to deposit gold coins for safekeeping. Upon taking a deposit the goldsmith would issue a receipt to the depositor. The receipt would be issued in 'bearer' form, meaning that any individual bearing it could claim back the face value in gold from the goldsmith on demand. As time progressed, the public found that the goldsmiths' receipts would be accepted in payment for goods and services. These receipts had become the earliest form of 'bank money'. As time passed goldsmiths realized that there was little need to lend the vault gold itself as their own receipts were by now regarded as money among the general public. A further step was taken when goldsmiths started issuing receipts to be lent out as a proxy for gold coins. This was of great

advantage to them as receipts could be manufactured at almost no cost, whilst gold could not be. By lending the receipts instead, the goldsmiths charged interest on the amount lent. Upon repayment, the receipts could be destroyed as easily as they had been manufactured, but the interest charged would remain as revenue.

**Interest & Debt**

One may not read the following facts and figures without horrors that between 1980 and 1992 the poorest countries in the world paid three times more to the IMF and the World Bank than their original debt. The poor countries of sub-Saharan Africa owe three times more than they can earn annually through exports. The debt burden of IMF and World Bank loans kills 19,000 children every single day. In Ethiopia debt repayments are four times greater than spending on health. In Tanzania, where 40% of the population dies before reaching 35, debt repayments are six times more than health spending.

Eleven Latin American countries met in Uruguay during March 1986 to discuss ways of trimming the interest bill on their $350-billion debt. The proposals to cut interest bill include a cap on the rate of interest, interest forgiveness and limiting debt service payments to a fixed percentage of export earnings.

American consumer debt is $112 billion through credit cards, $200 billions on auto loans, US $26 billions on home loans and US $184 billions on others. According to an ABC report in early 1986, 98.2% of American consumers have a hard time in making payments. They would pay bills of one credit card through another card and so on.⁵

During Regan’s President ship the U.S. debt position rose from $1 trillion in 1981 to US $2 trillion in 1986. Officials acknowledge that the major

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problem is not the debt but the interest. The interest for 1986 was $196 billion, which rose to US $207 billion by 1987.⁶

According to the latest reports, Argentina has defaulted its $726 million payment due to the World Bank. The Argentinean President Eduardo Duhalde in his statement said, “We do not like not paying our debts, but we are in a quandary: If we do not pay, we default on our debt, and if we do pay we will drain our reserves.”⁷

These are a few scattered reports highlighting the issue of debt, interest and their consequences upon the people and the government of the borrowing countries. Now there is no disagreement that debt based contracts is one of the most important factor responsible in making the present financial system highly vulnerable. There are many more aspects to this issue one of them is highlighted by, IMF Executive Director, Mirakhor Abbas, in these words: “there are now US $32 trillion of sovereign corporate bonds alone. Compare this to the production and capital base of the global economy and one observes an inverted pyramid of huge debt piled up on a narrow production base that is supposed to generate the income flows that are to serve this debt. In short, this growth in debt has nearly severed the relationship between finance and production. Analyst are now worried about “debt bubble”. For each dollar worth of production there are thousands dollars of debt claims. An Islamic financial system has the potential to redress this serious threat to global financial stability because of its fundamental operating principle of a close link between financial and productive flows and because of its requirements in risk sharing.”⁸

In the following sections we shall describe about the factors that led to emergence of Islamic economics and its financial system. It is a well-known fact that in Islamic economic system does not allow interest. However, there

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⁶ Ibid.
are more to Islamic economics than interest’s prohibition, we briefly describe here some other distinguishing features between both the systems.

Islamic Economics versus Conventional Economics

Prohibition of interest has not been the only factor responsible for the development of Islamic banking. Banking is just a part of overall economic system whether conventional or Islamic. Failure of the conventional economic theories to resolve out many contemporary problems like unemployment, inflation, increasing income inequality, along with the falling down of the myth of Philip curve, and many a times conflicting objectives of the conventional economic theories escorted the Muslim thinkers to reconstruct the objective of the economics as subject of social science. Chapra, a research advisor at Islamic Research and Training Institute (IRTI), submits that continued deviation of the conventional economics from normative to positive approach resulted in many conflicting objectives like.

A. Harmony between individual preference and social interest
B. Equal distribution of income and wealth.
C. Reflection of the urgency wants by prices.
D. Perfect competition

Chapra argues that market forces, unlike the presuming conventional economists, may not always be in harmony between the individual preference and the social interest. He cites the case of pollution, which is social cost to the society and any efforts to reduce it would violate the condition of Pareto’s optimality. He also asks why conventional economics does not take into

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9 The recent experiences of stagflation, high rates of unemployment existing simultaneously with high rates of inflation has raised serious doubts about the validity of the Philip’s curve, which postulated a stable tradeoff between inflation and unemployment.

10 Chapra, M.U., What is Islamic Economics, IDBs’ Prize Winning Lecture Series No. 9, Islamic Research and Training Institute (IRTI) and Islamic Development Bank (IDBI) Publication, 1996, p.19.
account the social costs resulting from lack of need fulfillment, unemployment, inequitable distribution and economic instability.

Inequality in income and wealth tend to be biased in favor of rich at the cost of poor. This diverts the scarce national resources in favor of production of status symbol, inessential unproductive goods at the cost of socially preferable need fulfilling items. For example Arthur Okun remarked that market tend to award prizes that allow the big winners to feed their pets better then the losers can feed their children.\(^{11}\)

The reason given by Chapra behind the market failure in his own word is that, “the secularist paradigm has led to an excessive commitment to neutrality between ends, abstinence from value judgments and choice primarily through the market” which is not in conformity with the needs of goal realization.\(^{12}\)

Contrary to this, Islamic economics is based on a paradigm, which has socio-economic as its primary objective. This objective takes its roots in the belief that human beings are the Vicegerents of the one Allah, who is the creator of the universe and every thing in it. They are brothers unto each other and all resources at their disposal are a trust from Him to be used in a just manner for the well being of all. They are accountable to Him in the hereafter and will be rewarded or punished for how they acquired and used these resources. In Islamic economics the human beings are not considered to be dependent primarily on maximizing wealth and consumption, rather it requires a balanced satisfaction of both the material and spiritual needs of the human beings. The fundamental difference between both the economic systems is well represented in their respective banking systems.


\(^{12}\) Chapra, M U., *What is Islamic Economics*, Op cit, p 23
The Idea of Islamic Banking

During initial stages on the discussion on Islamic banking there were differing opinion on definition of *riba* the first were of the view that all forms of fixed return on lending irrespective of its amount or percentage is *riba* and therefore prohibited. They argued, since interest, whether exorbitant or reasonable, is addition to the capital borrowed, it is a *riba* and therefore does not comply with the Quran. Thus, they define *riba* or interest, as any predetermined fixed return for the use of money. It was considered irrelevant whether the *riba* relates to loan for consumption or productive purposes, whether the loans are personal or commercial, whether the borrower is government, a private individuals or a company and whether the rate of interest is high or low.

Few were of the view that it is only usury (the exorbitant rate), which is exploitative therefore prohibited. They argued that since bank interest is a profit, earned on its operation, is not *riba*. They regard interest to be prohibited only when it is exorbitantly high and exploitative. Further, they were of the opinion that interest charges should be permitted when they are especially used:

- By the government to induce savings to finance trade.
- As a fine or punishment for debtors who have not fulfilled their obligations willfully, and
- for loans made to finance productive investment.

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13 Ahmad, Shaikh M., *Economics of Islam: A Comparative Study*, Shal Shal 1 ahon, 1952, p. 32
It was also argued that in an inflationary economy lender will be exploited due to fall in the future value of his money and since Quran does not permit exploitation therefore at least compensatory is not prohibited. Another part of the same argument is that, since Islam is the religion of all people and all times to come therefore, it cannot deny its people enjoying banking facilities or isolating its masses from such a large sector, this argument is based on the pretext that banking without interest is not possible at all.

There is a third group which has an opinion that modern banking because of it being principally based on riba may not be the necessary ingredient of Islamic economic system, few of the basic services which are provided by these banks like saving deposit, current deposit and vault facilitation etc. can also be provided by the bait-al Mal (public treasury). They argued that the bank interest is against the basic objective of Shariah.

Islamic economists gave various reasons for the prohibition of interest or riba, the three main among them are mentioned by Cummings et al:

- Interest or usury reinforces the tendency of wealth accumulation in the hands of few.

- Islam does not allow gain from financial activity unless the beneficiary is also subject to risk.

- Islam regards the accumulation of wealth through interest as selfish.

The main economic reason given for the prohibition of riba was that it hampers investment and employment and is always exploitative and brings

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instability to the economy.\textsuperscript{17} Some other reasons put forward by Islamic economists can be summarized as follows.\textsuperscript{18}

1) Transaction based on interest violates the equity aspect of economic organization. The borrower is obliged to pay a pre-determined interest on the sum even though he may have incurred a loss. A fixed charge on capital is unjust since the results of productive enterprise in which capital is invested are uncertain.

2) The inflexibility of an interest based system in loss situation leads to a number of bankruptcies resulting in loss of productive potential and unemployment. A system based on profit sharing is more stable than a system based on fixed charge for capital since the cost of capital in a sharing system automatically adjust itself to variations in productivity under changing business conditions. A shock to asset position is automatically absorbed on the liability side.

3) The interest system dampens investment activities because it adds to the cost of investment.

4) The interest-based system is security-oriented rather than growth oriented.

5) The interest-based system discourages innovation, particularly on the part of small-scale enterprises.

6) Under the interest based system banks are only interested in recovering their capital along with interest.

7) Under profit sharing system it is the real sector of the economy which determines the rate of return unlike in the financial sector which is based

\textsuperscript{17} Ahmad, Shaikh M., Economies of Islam: A Comparative Study, Shaikh M. Ashraf, Lahore 1952 p 32

\textsuperscript{18} Ahmad, Ziauddin, 'Concept and Models of Islamic Banking: An Assessment' paper presented at the Seminar on Islamization of Banking, November 27-29, 1984, Karachi, Pakistan and Abdullah, I. ud and Iqbal Munawar, 'Some Strategic Suggestions for Islamic Banking in the 21\textsuperscript{st} Century' in \textit{Review of Islamic Economics}, The Islamic Foundation, Leicester, UK Vol 9, 2000 p 41-44
on interest. This system (PLS) puts a check on the supply of money and controls inflation.

8) Risk sharing system will bring more innovation in the economy and encourage new entrepreneurs to venture into the market.

Mannan in his book *Islamic Economics: Theory and Practice*, sums up the Islamic view on interest in these words “Islam prohibit interest because interest has nothing to do in influencing the volume of savings, because it makes depression chronic, because it aggravates unemployment problem and, finally because it encourages unequal distribution of wealth”.19

In spite of all these debates on the harmful effects of *riba* the issue, however, kept haunting time and again in various Muslim countries till a universal and comprehensive definition of *riba* was adopted during the Islamic Conference held in Jeddah in 1973. On the basis of this the Islamic Fiqh Academy of the Organization of Islamic Conference (OIC), in the year 1985, adopted a definition of *riba* in these words, “any increase or profit on a loan which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay, and any increase or profit on the loan at the inception of the loan agreement, are both form of usury (*riba*), which is prohibited under the *Shariah*”.20

There is now a general consensus among Muslim religious scholars and economists that there is no difference between usury and interest and following characteristics define its prohibition.21

1. It is fixed *ex ante*.

2. It is tied to the time period and the amount of the principal.

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3. Its' payment is guaranteed by the borrower regardless of the outcome of the transaction for which the money is borrowed.

4. The state apparatus sanctions and enforces its collection.

Emergence of many Muslims states during first half of twentieth century gave impetus to the idea of Islamic banking, which caught swiftness by the 1970s. By 1980s several Muslim countries had started a concerted effort to Islamize whole of their economy and by the end of twentieth century there is hardly a country with substantial Muslim population where Islamic banking is not introduced. At present there are more than 300 Islamic financial institutions in different parts of the world enjoying about $300 billion of public deposits. Several western and conventional financial institutions have also started offering Islamic windows to their customers. (More about this in later part of this chapter)

The Rationale of Islamic Banking

The rationale of Islamic banking revolves around two basic questions. Firstly, is the financial intermediation necessary? And secondly, is the financial intermediation possible without interest?

As for the first question, Islamic economists are convinced that financial intermediation is necessary. In the words of Professor Sidiqi, “we suggest that financial intermediation is a necessity (darurah) in the full technical sense of the Shariah term. If an Islamic society does not have financial intermediaries it will either become weak and wither away or people alien to that society will takeover the function of financial intermediation with dire consequences for its financial as well as monetary system”.

Some other reasons mentioned by Islamic economists, for the necessity of financial intermediation, are the same as put forward by the conventional

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economists. For example, financial intermediation enhances the efficiency of the saving and investment process by reducing transaction costs and eliminating the mismatches inherent in the needs of surplus and deficit units of economy. Besides this agency problem arising due to asymmetric information is also reduced by financial intermediation. Munawar Iqbal et al stress that "Islamic financial intermediation endeavors to replace interest by other modes and instruments both for mobilizing savings and putting those savings into productive use. The functions that the banks perform are important whether the economy concerned is secular or Islamic. People need banking services. Now, since the banking services are needed but interest is prohibited. Islamic economies have to find alternative ways of performing various banking functions. This challenge provides the rationale of Islamic banking." 

As for the second issue i.e. is financial intermediation possible without interest or fixed payment basis. Islamic economists reply in affirmative. They are of the view that it is not only possible but more desirable and efficient in many ways. As noted in the Pakistan Shariat Court judgment on *riba*, "The writers on Islamic economics are unanimous on the point that banking system can discharge all its present day functions even without the element of interest. These thinkers also agree that the reorganizing banks on Islamic lines should be done on the basis of *Shirkah* and *Mudarabah*."

Modern commercial banking activity is based on creditor and debtor relationship where banks only play intermediary roles between the savers

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23 Agency problems arise when one party serves as an agent for another. The two major types of problems are that of moral hazard and adverse selection. Moral hazard arises due to hidden action when one party has the incentive to shift the risk onto another uninformed party. Adverse selection is due to hidden information, when one party has access to more information. Agency problem also occurs due to a conflict arising out of selfishness. Weak regulatory and legal systems worsen this problem. (For its analysis, see, Nadim ul Haq, 'Developing of Financial markets in Developing Economies'. Address at the Financial Reform Conference, Trans Asia Hotel, Colombo, Sri Lanka, March 18, 2002).


25 For more details please see the above section, 'the idea of Islamic banking'.

(depositors) and the investors (borrower). It charges higher interest from the borrower and pays lower to the depositor the balance (spread) is kept by the bank to meet its own costs and pay for its shareholders. This kind of creditor-debtor relationship is not permissible under Islamic framework. The other Islamic principle in matter of Islamic financial transaction is that there should be no reward without risk bearing. This principal is applicable both to labor and capital. As no payment is allowed to labor unless it is applied to work, no reward for capital is allowed unless it is exposed to risks. Financial intermediation in an Islamic framework is based on these two principles.²⁷

Shaikh Mahmud Ahmad searched through several theories of interest, developed since the time of Adam Smith, to show that there had been no satisfactory explanation of existence of a fixed and predetermined rate of return to financial assets. He went further; analyzing the writings of economists such as Keynes, Bohm Bowerk, Cassels, and Samuelson, to argue that an objective assessment of these writings would lead one to believe that all of these writers held a reasonably strong conviction that the existence of a fixed and predetermined rate of interest was an impediment to the process of economic growth and development. Mohsin S. Khan, in his article 'Islamic Interest-Free Banking: A Theoretical Analysis,' notes²⁸ that the abolition of interest-based transactions is not a subject alien to even western economic thought. Several western writers including Fisher, I., 100 % Money, (1945), Simons, H., Economic Policy for a Free Society, (1948) and Friedman, M., 'The Monetary Theory and Policy of Henry Simons,' in Friedman, M., (ed.), The Optimum Quantity of Money and Other Essays, (1969), among others, have argued that the current (one-sided liability) interest-based financial system is

²⁷ Cizaka, Murat, "Historical Background" in Encyclopedia of Islamic Banking & Insurance. Published by Institute of Islamic Banking and Insurance, London, 1995, p.17.

fundamentally unstable. In Simon’s view the basic flaw in the traditional system is that, as a crisis developed and earnings fell, banks would seek to contract loans to increase reserves. Each bank could do so, however, only at the expense of other banks.

Frequent economic and banking crises especially banking failures in the United States during 1930s and in 1980s only increased the consternation and led to belief that there is something fundamentally wrong with the banking sector. Many experts were of the view that fractional reserve banking system was inherently unstable and therefore should be replaced with two separate financial institutions. Such arguments for a profit loss based system have also been made in the wake of bank failures in other countries.

1. Deposit Banks with 100% reserves
2. Investment Trust, to perform the lending functions.

Mirakhor, Abbas, Executive Director of the International Monetary Fund (IMF), in his article Progress and Challenges of Islamic Banking speaks about the conventional economists who during late 1950s tried to answer two fundamental questions regarding banking that had not been addressed: (1) Why did banks develop and (2) why were all their operations based on fixed fee contracts? Mirakhor says that these questions were unfortunately, albeit indirectly, relevant to the theory of Islamic banking.

The explanation given for the existence of banks was “necessity of an intermediate between the preference of lenders for short term liquid assets and...

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29 Monetary economists insist that a zero nominal interest rate is a necessary condition for optimal allocation of resources. They argue that after switching from metallic to fiat money, adding one marginal unit of real balance costs no real resources to the community. Therefore, imposing a positive price on the use of money would lead traders to economize on the use of money, in their pursuit to minimize their transaction costs. They would therefore use some real resources instead of money. However, when the rate of interest is zero traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment.

30 Khan S. Mohsin, Op cit., p 9


the preference of borrowers for long term illiquid liabilities. Another was that banks being operating at high volume enjoy benefits from economies of scale. According to Mirakhor, the second question why do banks operate at fixed fee basis has been much harder to explain, not only this but many other related questions regarding interest rate ceilings on bank liabilities and other controls and regulations like reserve requirements, control on assets and entry and deposit insurance needed answers.33

By the mid 1980, economic and financial theory had demonstrated that there were disadvantages in the fixed pay off contracts that dominated interest based banking because; following conclusions were drawn for fixed pay off contracts;34

- These contracts create inefficient default or non-performing assets.
- In the presence of asymmetric information, debt contracts suffer from adverse selection effects and moral hazard effects.
- Reserve requirements gave unnecessary extra liquidity to the regulatory authority, which in many cases aggravated the fiscal imbalance.
- Deposit insurance reduced the depositor’s willingness to watch the functions of these banks. All the above had an adverse effect on the functionary of these banks especially during crises.
- Fixed fee contracts create a fundamental conflict between the interest of the borrowers and the lenders.
- Socially desirable sectors with low profitability will not get finance more over new entrepreneurs with good projects may not get finance in absence of security required.

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33 Ibid., p. 6.
It has been observed that during the crises, to attract more deposit these institutions have increased their deposit rates while their earning reduced they trapped into the crises.

On the contrary, Islamic banks are those, which are based on equity finance and are more immune to such crises. The real value of their assets and liabilities would be equal to all points to time. There will be a close relationship between investment and deposit fields.

Return on liability is the direct function of the return to assets.

Adjustment to shock that results in banking crises and disruption of the payment mechanism is more rapid than in conventional system.

Factors for Rapid Growth of Islamic Banking

A systematic analysis of the evolution of the Islamic banking can broadly be grouped into the following two;

1. Theoretical preparation (Islamic banking as an idea)
2. Practical Efforts (Establishment of various banking and financial institution in different parts of the world).

The Theoretical Preparation for Islamic Banking

Theoretical development of Islamic banking can broadly be divided into following subheads;

1: Early writings on Islamic Banking

There are several writings of the classical Islamic economists who are considered to be the founding pillars of the modern Islamic banking. Their ideas were taken up and followed by others in the later years for further
developments of the Islamic banking. Owing to fast developments during recent years, the works of these writers may not be looked as much clear in perception but they obviously are considered to be the architects of Islamic banking mainly for conception and proposition of their ideas.

An analysis of the literature on the subject reveals that during the first half of the 20th century, almost half of the total literature available in the world was in the Urdu language the rests being either in English or in Arabic language.35

Some Muslim intellectuals and fiqaha (Jurists) like, Maulana Syed Abul Ala Maudoodi, Imam Muhammad Baqir al-Sadr, Anwar Iqbal Qureshi, Mohammad Nejatullah Sidiqi, Muhammad Uzair and Ahmad al-Najjar are considered to be the pioneers of the Islamic banking movement.36

have also dealt on Islamic banking. Hamidullah Siddiqui’s, *Anjuman Qard Hat Bila Sood*, (Interest Free Loan Society) article in ‘Maarif’, 1944, gives the account of first practical effort in the field of Islamic banking; his several other writings, *A Suggestion For an Interest Free Islamic Monetary Fund* (1955), and *Interest Free Lending Banks* (1962) also belong to the above category. Some other mentionable works are summed up in the (table, 3.1)

**Table No. 3.1**

<table>
<thead>
<tr>
<th>Writer</th>
<th>Title of the Book</th>
<th>Year of Publication</th>
<th>Language</th>
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<tbody>
<tr>
<td>Naeem Siddiqui</td>
<td><em>Islami Usool Par Banking</em></td>
<td>1948</td>
<td>Urdu</td>
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<tr>
<td>Maulana A.A. Mawdudi</td>
<td><em>Sood</em></td>
<td>1951</td>
<td>Urdu</td>
</tr>
<tr>
<td>Shaikh Ahmad Irshad</td>
<td><em>Bila Sood Bankari</em></td>
<td>1964</td>
<td>Urdu</td>
</tr>
<tr>
<td>Mohammad Akram</td>
<td><em>Islami Maishat Men Bank aur Bachaten</em></td>
<td>1965</td>
<td>Urdu</td>
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<tr>
<td>S Hasanuzzaman</td>
<td><em>Interest free consumption Loans and Consumer Behaviour</em></td>
<td>1964</td>
<td>English</td>
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<tr>
<td>R K Ready</td>
<td><em>Egyptian Municipal Savings Banks Project</em></td>
<td>1967</td>
<td>English</td>
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<tr>
<td>Shaikh Mahmood Ahmad</td>
<td><em>Banking in Islam</em></td>
<td>1969</td>
<td>English</td>
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<tr>
<td>Muslehuddin Ahmad</td>
<td><em>Banking and Islamic Law</em></td>
<td>1974</td>
<td>English</td>
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<td>Shalibi Ahmad</td>
<td><em>Islamic Bank</em></td>
<td>1969</td>
<td>Arabic</td>
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<tr>
<td>Mohammad Issa</td>
<td><em>Banks Without Interest</em></td>
<td>1970</td>
<td>Arabic</td>
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<tr>
<td>Baiyun Nuri Abdussalam</td>
<td><em>The Shape of The Banking System in Islamic Economy</em></td>
<td>1972</td>
<td>Arabic</td>
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*Source: M N Siddiqui, Muslim Economic Thinking A Survey of Contemporary Literature*
Muhammad Nejatullah Siddiqi’s *A Model of Interest Free Banking* and Ghair Sudi Bankari (*Banking Without Interest, 1969*) are considered few of the important contributions to Islamic banking in many respects. In his book Professor Siddiqi has dealt with a banking model, creation and control of credit, consumer and government finance, and provision for short-term interest free loans to business. He has also introduced certain financial papers to replace bonds and securities.

Mohammad Uzair’s *An Outline of Interest less Banking* (1955) has the distinction of being the first published work exclusively devoted to the subject of Islamic banking. Another of his work, *Factors Contributing to the Success of Interest Free Banks* (1958) is also worth mentioning.

It may be noted that the majority of the second-generation writers on Islamic banking, unlike first generation that mainly consisted of Ulama, belonged to professional economists.

The period from 1930 to 1974 is characterized by theoretical writings on Islamic economics and banking, which can undoubtedly be described as the foundation period of Islamic banking. Most important writings of the period include Muhammad Uzair (1955), Mohammad Nejatullah Siddiqi 1961, 1969, Abdullah Ali Arabi, 1967, Baqir-al- Sadr 1961, 1974 and Ahmad-al-Najjar. 1971.17

2: Seminars, Conferences, Committees and Institutions

Seminars and conferences have played a vital role in the concept, development and practices of the Islamic banking. In this regard Finance Minister’s conference in Karachi in 1970 and Egyptian study of 1972 are path breaking in many respects. However, it was the first International Conference on Islamic Economics held at Makkah 1976 that served as a catalyst at an

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international level and led to an exponential growth of literature on the subject. Islamic Fiqh Academy Seminar at Jeddah in the year 1985 is important in respect that a common definition of Riba was the outcome of this seminar. A consensus on the definition of Riba that ended all previous speculation and controversies. Some other seminars, committees, and conferences, which had played an important role in the development of the discipline and have become a regular feature since 1970s and kept the tempo of Islamic banking high, are mentioned in the table 3.2

Table No. 3.2

Some Important Conferences and Seminars on Islamic Banking

<table>
<thead>
<tr>
<th>Conference</th>
<th>Place</th>
<th>Year</th>
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<tbody>
<tr>
<td>1st International Conference on Islamic Economics</td>
<td>Makkah</td>
<td>1976</td>
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<tr>
<td>The Conference on Islamic Banking and Strategies for Economic Cooperation</td>
<td>Baden Baden</td>
<td>1982</td>
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<td>The Second International Conference on Islamic Economics</td>
<td>Islamabad</td>
<td>1983</td>
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<td>Conference on Islamic Banking Its impact on world financial and commercial practices</td>
<td>London</td>
<td>1984</td>
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<td>Workshop Industrial Financing Activities of Islamic Banks</td>
<td>Vienna</td>
<td>1986</td>
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<td>International Conference on Islamic Banking</td>
<td>Tehran</td>
<td>1986</td>
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<td>International Conference on Islamic Banking and Finance Current Issues and Future Prospects</td>
<td>Washington DC</td>
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<td>Islamic Banking Conference</td>
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<td>Islamic Banking Conference</td>
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<td>Islamic Banking Conference</td>
<td>Toronto</td>
<td>1997</td>
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<tr>
<td>4th International Conference on Islamic Economics, Banking and Finance</td>
<td>Loughborough</td>
<td>2000</td>
</tr>
</tbody>
</table>

Sources: Various issues of Islamic Economic Studies and Islamic Economics Bulletin

18 Chapia M U 'What is Islamic Economics' Op cit, p 48
3: Compilation of Previous Works

Proper recording and compilation of previous works is important in many respects. It is an indicator of the direction and development of the subject. One of the most important and path breaking work under this category was done by Muhammad Nejatullah Siddiqi *A Survey of Contemporary Literature on Islamic Economics* it was prepared in 1974 and published in 1980. Another important work by Siddiqi, published in 1982 is *Recent Works on History of Economic Thought in Islam: A Survey*, this paper surveys the recent writings in Arabic, English and Urdu on the economic thinking of twenty seven eminent Islamic thinkers of the past from Imam Abu Hanifa to Allama Iqbal. Few other important works in this field includes M. Akram’s. *Annotated Bibliography of Contemporary Economic thought in Islam and Glossary of Islamic Terms in Islam* prepared in 1973. It has compiled the work done in the field in English and Urdu languages. This bibliography was first published in 1983; another important work published in 1974 is done by Atiyah Jamal al- Din *Dalil al Bahith fil Iqtisad al-Islami* Arabic (A Guide to Researcher in Islamic Economics).

M. A. Mannan’s *Abstracts of Researches in Islamic Economics*. 1984. is the listing of the works carried out by International Centre for Research in Islamic Economics (ICRIE) either independently or in collaboration with others. Nazim Ali and Nasim Ali (1994) have compiled several important works in their book, *Information Sources on Islamic Banking and Economics 1980-1990*. This work covers the writings during the period of 1980 to 1990. The latest important addition in this field is *Islamic Economics & Finance A Bibliography* by Javed Ahmad Khan, published by Mansell, U.K. in 1995.

4: Research Paper and Magazines

Various magazines and publications have become a regular feature on the subject of Islamic economics, finance and banking. Occasional papers,
seminar proceedings published by various institutions like Islamic Research and Training Institute, (IRTI), Islamic Development Bank (IDB). The Islamic Foundation, UK, Center for Research in Islamic Economics, (CRIE) have played important role in disseminating the information on the discipline. Harvard Islamic Finance Information Programme (HIFIP) has become one of the important annual features for Islamic finance during last few years. Some of the important magazines and journals on the subjects are; Review of Islamic Economics, UK, Islamic Economic Studies, Jeddah, King Abdul Aziz University Journal of Islamic Economics, Jeddah. Islamic Economic Bulletin. Aligarh. India, Journal of Islamic Economics, Malaysia, Thoughts on Economics. Dhaka, Bangladesh, Journal of Islamic Banking and Finance, Karachi. and New Horizon, Institute of Islamic Banking and Insurance, UK. etc.

5: Research Institutions and Professional Associations

Several organizations and research institutes have played important role in the development of concept and practices of Islamic banking. However, few of the organizations are specifically devoted to the cause of Islamic banking practices that includes; the International Association for Islamic Banks, Accounting and Auditing Association for Islamic Financial Institutions (AAOIFI), Institute of Islamic Banking and Insurance (IIBI), and the recently Islamic Financial Services Board.

(a) The International Association of Islamic Banks (IAIB): Established in 1977 by the Islamic Development Bank. This association is playing an important role in the meeting of central banks and monetary agencies of the Islamic countries as well as the meetings of the specialized

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39 The Association of Muslim Social Scientist, U.S.A. (1972); the Islamic Foundation, Leicester, U.K. (1973); Islamic Economics Research Bureau, Dhaka, Bangladesh (1976); the Center For Research in Islamic Economics, the King Abdul Aziz University, Jeddah (1977); the International Institute of Islamic Thought, Herndon, Virginia, U.S.A. (1981); the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (1983); the International Institute of Islamic Economics, Islamabad (1983); the International Association for Islamic Economics (1984).
bodies of the OIC in the field of banking and insurance. The association aims to strengthen ties between Islamic financial institutions, fostering cooperation, coordinating their activities and monitoring their operations to insure that they conform to Shariah. It provides technical assistance and expertise to the people wishing to establish Islamic banks. It also represents the common interests of Islamic banks at national and the international level.

(b) Accounting and Auditing Association For Islamic Financial Institutions (AAOIFI): Is a self-regulated organization founded by Islamic banks worldwide in 1991. It is striving to regularize accounting across Islamic banking. It has established sixteen accounting standards including four on accounting, and three on governance. It has also started issuing Shariah standards.

(c) Institute of Islamic Banking and Insurance (IIBI): Established in 1993 to render a service to Islamic banking & insurance. The institute offers a diploma course in Islamic banking and insurance and publishes a monthly called New Horizon. Its main objectives are as follows;

1) Promotion of knowledge of Islamic banking and insurance through conferences, seminars, lectures and publications.

2) Education of personnel in Islamic banking & insurance.

3) Assistance and advice on all aspects of Islamic banking & insurance.

4) Development of Islamic financial institutions.

5) Study and research on issues and problems in the field of Islamic banking & insurance.

(d) Islamic Financial Services Board (IFSB): A Malaysia based organization is recently established by the Islamic Development Bank (IDB). Accounting and Auditing Association For Islamic Financial Institutions (AAOIFI) with the active collaboration of the International Monetary Fund (IMF). According to IMF sources the IFSB will serve as an association of
institutions that have responsibility for the regulation and supervision of the Islamic financial services industry and will:

I. Set and disseminate standard and core principles as well as adapt existing international standards for supervision and regulation, consistent with Shariah.

II. Liaise and cooperate with other standard setters in the areas of monetary and financial stability.

III. Promote good practices in risk management in the industry through research, training and technical assistance.\(^{40}\)

**The Practice of Islamic Banking**

Endeavors to establish interest free financial intermediary has been made in different countries at different times. Initially the purpose to establish such institution was avoidance of interest and providing cost free loans to the needy. In the beginning, we find individual level efforts at different parts of the world some in the form of Baitul Maals, Anjuman (Associations), cooperatives, non banking companies, nidhis or even in the form of banks but avoiding the name Islamic for fear of annoying the hostile political establishment in the country.\(^{41}\)

During Muslim ascendancy Baitul Maal were catering to the economic needs of the people. As Muslim power declined and replaced over by the Europeans who established modern banks functioning on the basis of interest. Muslim not happy with these institutions tried to reestablish their old format i.e. Baitul Maals the first such examples can be found during the last decade of the 19\(^{th}\) century when a prominent scholar of Hyderabad, India tried to establish an interest free institution called ‘Anjuman Mowudul Ikhwani’. this

\(^{40}\) *International Monetary Fund*, News Brief, No. 02/41, May 1, 2002.

\(^{41}\) The First highly acclaimed modern Islamic bank ‘Mit Ghamr’ was not named Islamic due to this fear.
was followed by another such institution in Hyderabad called *Anjuman Imadad-e-Bahmi Qardh Bila Sud* established in 1923 by the employees of the Department of Land Development (*Mohakm-e-Bandobast-w-Dakhila Huqooq-ul-Aradhi*), within 20 years of its establishment this organization had an asset worth Rs. 100,000 this *Anjuman* (Association) was distributing Rs. 5000-6000 loans per month and enjoyed a membership of 1000 (Muslims and Non-Muslims) with a reserve of Rs. 3000 in 1944.\(^4\) During the period of Aaasafia, 12 such organizations had established, few of them continued till partition of the country in 1947.

In Pakistan, the first modern banking venture adhering to the tenets of Islamic law was founded in the late 1950s. A few landlords who voluntarily contributed interest free deposits to the fund backed the institution; credit was advanced to poorer landlords for agricultural improvements. No interest was charged for the credit, but there was some administrative fee to cover operating costs. Increasing demands of loan not backed by corresponding deposit soon led to collapse of this pilot project.\(^5\)

Some other experience in this field continued in the form of Cooperatives and Muslim Funds. However, it was only in 1963 when a first so called modern Islamic bank *The Mit Ghamr Local Saving Bank* could be established in Egypt. Since then there is spurt in Islamic banking activities. By the period 1997 the number of Islamic financial institutions rose up to 176 with deposits of around U.S. $112 million and assets worth U.S. $147 million. At present there are about 300 Islamic banks with more than $250 billion deposits.

Since Islamic banking is a recent phenomenon there is not much innovation in its services. Neither are there too many kinds of Islamic banks

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like in conventional i.e. central, commercial, cooperative, regional, developmental etc. For the purpose of study we can divide these Islamic banks into two chronological orders.

**Those Established Before 1980**

Institutions established before 1980 were mainly the result of three kinds of efforts. Individual, community and governmental, these efforts were easily reflected in the character of the institutions.

As mentioned above that the first modern effort to establish interest free institutions can be traced back to 1890s in the southern India. This was mainly a welfare association collecting donations and skins of animals sacrificed during festivals from the public and providing interest free loans to the needy. Another such institution called ‘Anjuman Imdad-e-Bahmi Qardh Bila Sip’ (Interest Free Credit Society) was also established in Hederabad. (Duccan) India during 1923.44

Patni Co-operative Credit Society, a Surat based institution, which still continues its business was established in 1939.45 In 1940 Muslim Fund Tanda Baoli, Rampur (a district in North India) was established, however, partition of India badly affected the functioning and further establishment of such societies, especially in Indian part, for fairly a long period. Muslim Fund Tanda Baoli was closed down due to partition effect. After a long gap of almost 15 years few social and religious organizations like Jamiat-e-Ulama-e-Hind and Jamat-e-Islami Hind again took the initiative in establishing interest free institutions. The first to be established then was Muslim Fund Deoband in the year 1961.

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44 Hamidullah, Mohammad, ‘Interest Free Credit Society’. op. cit.
which is still working with public deposits over Rs. 90 million. According to the information provided by the Federation of Interest Free Organization (FIFO) there are more than hundred Muslim Funds in the country. Of them, thirty Muslim Funds are the members of FIFO. Toor Baitul Mal, Hyderabad was established in 1966, and Muslim Fund Najibabad (MFN) in 1971, this group is the largest Muslim Fund in the country with more than 40 branches all over India and around 200,000 shareholders. It enjoys deposits of around Rs. 360 million. Muslim Fund Najibabad has also floated a subsidiary called Al-Najib Milli Mutual Benefits Ltd. in the year 1990.

Bait-un-Nasr, Urban Co-Operative Credit Society (BUN) India’s largest and most professional Islamic financial institution was established in the year 1973. BUN is the largest Cooperative Credit Society in any of the Metros of India with more than 155050 shareholders and 20 branches with deposits around Rs.125 million and loan turnover of more than Rs. 365 million in the city of Mumbai alone. Few restrictions including prohibition to function outside the geographical boundary of Mumbai resulted in the formation of Barkat Investment Group in the year 1983.

In other parts of the world as well independence of many Muslim states by the period of 1950 gave momentum to the idea of Islamic banking and so to their establishment. The most glaring example of this period was the establishment of the Mit Ghamr Local Savings Bank in Egypt in 1963 by a noted social activist Ahmad-al-Najjar. It is widely accepted as the first modern

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46 For more details about Muslim Funds please see, Khan Javed Ahmad and Nisar Shariq, Collateral (Al-Rahn) As Practiced by Interest Free Credit Societies: With Special Reference to Muslim Funds in North India, (Research Paper Submitted to King Abdul Aziz University, Jeddah). November 2002, pp36.

47 Federation of Interest Free Organization (FIFO) is an apex institution of Muslim Funds in India. FIFO extends credit facility to Muslim Funds at the time of crunch. It also provides training and other facilities to its members.

48 Dalvi, M. Abdul Wahab, “Random Thoughts on Some Economic and Legal Challenges to Islamic Banking System” Paper Presented at the Seminar on “Islamic Economics Issues and Challenges” Organized by the Indian Association For Islamic Economics (IAFIE) at New Delhi, India in October 1999.
Islamic bank. It performed all the functions of a modern Islamic bank. This experiment combined the idea of German savings banks with the principle of rural banking within the general framework of Islamic values. This experiments, however, lasted for four years only.

Another unique experience of this period was the establishment of the ‘Pilgrims’ Management and Fund Board of Malaysia’, popularly known a ‘Tabung Haji’ in the year 1963. The reason for the establishment of this institution was the desire of Malaysian Muslims that money spent on pilgrimage must be clean and untainted with *riho*, since this was not possible by depositing the money with ordinary commercial banks, the Pilgrims’ Saving Corporation was established which latter incorporated into the Pilgrims’ Management and Fund Board in 1969.

Nasir Social Bank established in 1971 by a Presidential decree was the first example of the interest of government in establishment of an interest free institution. The establishment of Dubai Islamic Bank by some traders followed it in 1975. It was an outcome of the private initiative.

**Islamic Banks 1980- 2000**

This period is characterized by the high growth of Islamic banks in terms of volumes as well as in numbers. More than 150 institutions have been established the turnover and deposits too have increased many fold. Almost every Muslim country including some western and Muslim minority country has seen the establishment of Islamic banks. Many conventional banks too had opened Islamic windows to cater for its customers. Various high level committees have been established to evaluate the performance of these banks. Islamic banking has achieved new heights in this period, various innovations have taken place. They have moved from traditional methods of funding to financial engineering. This is also combined by the various issues Islamic banks are facing. Now various comparative studies of Islamic banks vis-à-vis
conventional banks have exposed Islamic banks to new competitions. Financial returns of the Islamic banks are also compared now with those of interest-based banks.⁴⁹

Anthony Cook, Senior Vice President of Brown Brothers Harriman the U.S. Private Banks, says; “Twenty years ago, Muslim Investors who wanted to invest under Shariah, had the option of earning zero interest. But since then, a number of organizations have created Islamic investments outlets and, by legitimizing and professionalizing them, they have opened up opportunities for a much longer audience”.⁵⁰

Table (3.3) shows the geographical distribution of Islamic banks by the period of 1997. The total number of institutions, as per the information provided by the International Union of Islamic Banks, is 176 of these the maximum concentration is in South and South East Asia, which has 47 institutions this is followed by Africa which accommodates 20 Islamic financial institutions. As per the number of institution third place is occupied by Middle Eastern Countries i.e. 15 and the GCC countries having the total number of Islamic financial institutions in their region is only 12.

Table No. 3.3

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of Institutions</th>
<th>%age</th>
</tr>
</thead>
<tbody>
<tr>
<td>South and South East Asia</td>
<td>82</td>
<td>47</td>
</tr>
<tr>
<td>Gulf Cooperation Council</td>
<td>21</td>
<td>12</td>
</tr>
<tr>
<td>Other Middle Eastern Countries</td>
<td>26</td>
<td>15</td>
</tr>
<tr>
<td>Africa</td>
<td>35</td>
<td>20</td>
</tr>
<tr>
<td>Europe and America</td>
<td>12</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>176</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Directory of Islamic Banks and Financial Institutions 1997

Table (3.4) shows the deposit wise position of each region. In this category the first place is occupied by the GCC region which enjoys more than 64% of the total deposits of the Islamic financial Institutions, followed by other Middle Eastern countries which controls around 19% of the total deposits. Rests of the regions have negligible deposits proportion in comparison to the over all average.

Table No. 3.4
Funds Managed by Islamic Financial Institutions by Regions (1996)

<table>
<thead>
<tr>
<th>Region</th>
<th>Funds Managed ($ million)</th>
<th>%age</th>
</tr>
</thead>
<tbody>
<tr>
<td>South and South East Asia</td>
<td>2250.7</td>
<td>8.2</td>
</tr>
<tr>
<td>Gulf Cooperation Council</td>
<td>17834.5</td>
<td>64.7</td>
</tr>
<tr>
<td>Other Middle Eastern Countries</td>
<td>5430.1</td>
<td>19.7</td>
</tr>
<tr>
<td>Africa</td>
<td>334.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Europe and America</td>
<td>1723.0</td>
<td>6.2</td>
</tr>
<tr>
<td>Total</td>
<td>27573.0</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Directory of Islamic Banks and Financial Institutions 1996.

During the last few years the deposits and businesses of Islamic banks and other financial institutions have multiplied many folds. And according to information provided by BBC, the Islamic banking is serving 1.2 billion Muslims and is valued at $180 billion.\(^{51}\) Another estimate values the assets of Islamic financial institutions to the tune of $230 billion that is more than a 40-fold increase since 1982.\(^{52}\) Yet another report by *New Horizon* suggests that there are more than 200 Islamic financial organizations operating in the world and managing funds over $300 billions.\(^{53}\)

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\(^{52}\) www.islamicbanking-finance.net

\(^{53}\) *New Horizon*, Institute of Islamic Banking and Insurance, London, April, 2002, p.2
Islamization of Financial System

Measures to Islamize the financial system have been introduced in several countries like Saudi Arabia, Kuwait, Sudan, the U.A.E., Bahrain, Jordan, Malaysia and Pakistan and Iran. Early eighties is specially mentionable in this regard when full fledge governmental efforts were noticeable to Islamize the entire economy in Pakistan, Iran and Sudan, which we shall discuss in the following sections.

Islamic Banking in Pakistan

It was first attempt of any modern Muslim State towards the Islamisation of its economy. In September 1977 the President of Pakistan asked the Council of Islamic Ideology (CII), the top Islamic body of experts that advises government of Pakistan on religious issues, to prepare a blue print of an interest free economic system and set a time limit for the elimination of riba from economy. The council appointed a panel of economists and bankers, which submitted its reports in February 1980, which after several consideration and modification was adopted in the year 1980.\textsuperscript{54} And by January 1981, all domestic commercial banks had started accepting deposit on the basis of profit and loss sharing (PLS). Over the next three years, steps were taken to develop new non-interest bearing financial instruments in which PLS deposit could be invested. Further steps were instituted in January 1985 to formally transform the banking system to one based on no interest within next six months. However, transaction with the government continued to be based on interest.

The Supreme Court of Pakistan in its landmark judgment ordered the government of Pakistan to transform whole of its financial system in tune with Shariah compliance by July 2001. In a landmark decision, the Supreme Court

in Pakistan in January 2000 has ordered that the country convert its financial system to an Islamic one by June 2001.\textsuperscript{55}

**Islamic Banking in Sudan**

The process of Islamic banking started in 1977 with the establishment of Faisal Islamic Bank, Sudan (FIBS). By 1983 three more banks had opened: Tadamun Islamic Bank, Sudan (TIBS), Sudanese Islamic Bank, and Islamic Co-operative Bank. Since September 1983 the whole Financial System of Sudan was started to be converted to the Islamic model.

During the period of 1985-1989 many of the recently converted Islamic banks were reverted back to their original conventional operations. This is the period when Islamic banks were forced to operate in an extremely hostile environment characterized by negative media coverage, lawsuits and heavy regulations.\textsuperscript{56} Since 1989 after the coming into power of the Islamic Salvation Front, the whole economy has again been transformed to conform to Islamic Law.

**Islamic Banking in Iran**

Following the Islamic revolution in 1979 the Iranian authorities took steps to bring the banking system’s operation into correspondence with the requirements of Islamic law. Since February 1981 the Bank Markazi (Central Bank Iran) started taking administrative steps towards elimination of interest from banking operations. A high level commission composed of bankers, academics, businessmen and Shariah scholar prepared a legislation for the elimination of riba from the economy which was passed by the parliament in August 1983 as the law for usury free banking. The law required the banks to

\textsuperscript{55} Latest Decision of Pakistan Supreme Court is discussed in chapter six.

convert their deposits in line with the *Shariah* within one year, and their total operations within three years, from the date of passage of the law, and specified the types of transaction that must constitute the basis for assets and liabilities acquisition by banks.\textsuperscript{57}

**Islamic Banking in South Asia**

**Bangladesh**

Two professional bodies "Islamic Economics Research Bureau" (I:RB) and "Bangladesh Islamic Bankers Association" (BIBA) took the practical steps for imparting training on Islamic Economics and banking to a group of bankers and arranging some national and international seminars/workshops to mobilize local and foreign people and attract investors to come forward to establish Islamic bank in Bangladesh.

Islami Bank Bangladesh Limited; is considered to be first interest-free bank in South East Asia, incorporated on 14\textsuperscript{th} March 1983. Al Baraka Bank Bangladesh Limited (Al-Baraka); the second Islamic bank of the country commenced banking business as a scheduled Islamic bank on May 20, 1987. Al-Arafah Islami Bank Limited (Al-Arafah) was incorporated in 1995 and started operation as 3\textsuperscript{rd} Islamic bank in the private sector banking in Bangladesh from September 1995. Social Investment Bank Limited (SIBL); the fourth Islamic bank in Bangladesh. It was incorporated in 1995. Faysal Islamic Bank of Bahrain (FIBB) is functioning in Bangladesh with effect from 11\textsuperscript{th} August 1997.\textsuperscript{58}

Besides the five Islamic banks as mentioned above, the Prime Bank Limited has opened two Islamic banking branches in 1995 and 1997.


respectively, while Dhaka Bank Limited has started operation with an Islamic branch along with the conventional banking operations since inception of the bank on July. 1999.59

Malaysia

From a modest beginning in 1963, with the establishment of the Malaysian Pilgrims Fund ‘Tabung Haji’ to the establishment of first Islamic bank in the country in 1983 the country has witnessed tremendous economic developments. Malaysia is probably the only Muslim country that has substantially succeeded in developing a strong indigenous Islamic banking and financial sector. Further, it is the only Muslim economy, which has a strong industrial base, with GDP growing at annual rate of 8 per cent. Over the last 30 years it has invested large sums of money in education, roads and transportation systems, telecommunications, and industrial manufacturing.

For the experts of Islamic banking, Malaysia is among the countries that have gotten the highest prospects for Islamic banking in the world. In the words of Zamir Iqbal and Mirakhor Abbas, “It is not an accident that Islamic banking is making its most promising progress in Malaysia. This country has one of the least repressive financial systems, no fiscal deficits, low inflation, low interest rates, and a dynamic and vibrant equity market as well as a strong private sector” 60

Established in 1983 Bank Islam Malaysia, Berhad (BIMB) is a single full-fledged Islamic bank in the country, it has 75 branches in different parts of the country. Islamic Banking Act was passed in 1983 immediately after the establishment of Bank Islam Malaysia Berhad. Interest free banking scheme known as Skim Perbankan Taupa Faedah (SPTF) introduced in March. 1993.

59 Ibid.

Another bank, Bank Muamalat Malaysia Berhad (BMMB) launched in October 1999. National Syariah Advisory Council (NSAC) is the highest Shariah authority on Islamic banking and Takaful (Islamic insurance) was established in May 1997. A higher learning institute, a college of Islamic Banking and Finance, popularly known as KPKI (Kolej Perbankan dan Kewangan Islam) was established in 1998 to give a boost to the knowledge of Islamic banking. By the end of 1999 fifty-two financial institutions including 22 commercial banks were offering Islamic Financial services, they enjoyed RM 35754 million of assets, RM 24739 million of deposits and RM 14007 million of financing facilities.

The year 2001 marked a significant period for the Islamic banking industry. In terms of performance, the industry registered encouraging growth during the year. According to the Governor of the country’s Central Bank, the total assets of the Islamic banking increased by 25.2%, amounting to RM58.9 billion as at end-2001 representing 8.2% of the overall banking system. In terms of profitability, significant growth was recorded with an increase in pre-tax profits by 69.9% to RM905.9 million during the year. Among the measures implemented in 2001 to further develop and strengthen the regulatory framework of the Islamic banking industry were the adoption of Risk Weighted Capital Ratio (RWCR) framework; the implementation of Rate of Return (ROR) framework; and the implementation of training and awareness programmes. In the area of research and training in Islamic banking and finance, an industry-owned institute named Islamic Banking and Finance Institute Malaysia (IBFIM) was established.61

Malaysia has played important role in establishment of the International Islamic Finance Market (IIFM) and the international standard-setting body

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Indonesia

It is the latest entrant in the field of Islamic banking. Bank Maumalat established in 1992 is the first Islamic bank in the country. In its short history it has focused largely on rural lending, small and medium enterprises. Bank Syariah Mandiri was founded by the merger of four bankrupt banks under the government’s bail out programme by launching a Shariah division in 1999 is the second Islamic bank of the country.

Brunei & Thailand; In Brunei the first Islamic bank, Bank of Brunei Berhad was launched in January 1993. While the government of Thailand has allowed for the establishment of Islamic bank in the country during 2001. Thailand is also organizing an important conference on Islamic banking in the year 2002.

India

A country, which can rightly be credited to have played a pioneering role in the development of Islamic finance and interest free credit societies, a country that has produced many prominent writers of the contemporary Islamic finance world, is yet to grant permission for Islamic banks in the country. Banking system of the country is still governed on the basis of laws made during colonial rules with modifications from time to time. To cater for their need Muslims in India have taken the route of cooperative credit society and non-banking finance corporations (NBFC), the prominent among them have been Bait-un-Nasr and Barkat Group of Bombay, Al-Ameen Group of Bangalore and Muslim Fund Group of Najibabad.

62 See the above section, ‘The Practice of Islamic Banking’ and ‘Those established before 1980s’.
Barkat Group established in 1983 is an offshoot of Bait-un-Nasr Bombay this group flourished very fast till 1997. All India Council of Muslim Economic Upliftment (AICMEU) and Baitul Maal of Bombay were established in 1984, while Al-Ameen, Bangalore, started its business in 1986. Syed Shariyat and Al-Baraka Finance House Ltd. (Now Al-Barr) were established in 1989. Baitul Islam and Assalam Finance and Investment were established in 1990.

In 1994 Barkat and Muslim Fund Al-Najib group joined together to market aggressively the concept of Islamic finance. This tie swelled up the deposits to Rs. 550 million with 60 Branches all over India.

In the year 1996 Barkat Investment Group along with some other Islamic financial institutions convinced India’s premier business house the Tata Group to launch a mutual fund scheme specially designed for Muslims in view of their inhibitions towards interest. The scheme named ‘Tata Core Sector Equity Fund’ TCSEF succeeded in raising Rs. 230 million from the public.

The non-banking financial companies (NBFCs) crisis during late 1990s resulted in revocation of the licenses of many Islamic financial institutions and after the liquidation of Barkat Investment Group in May 2000, the Islamic financial activities, in India, have got big setback. With the closure of Bait-un-Nasr (the oldest and most professionally managed cooperative society) the future of Islamic financial institutions in the country looks bleak.

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63 Barkat Investment Group marketed for Al-Najib Milli Mutual Benefits Ltd. in South India, opened its branches there and run on its own, however it avoided joining Al-Najib in its operation in the North India as it was not fully convinced about its dealing from Islamic point of view. Al-Najib Milli Mutual Benefits Ltd. did the same for Barkat in the North but had no control over Barkat’s operation.

64 Now Tata I.T.Sector Fund, Barkat Investment Group was only a marketing associate of Tata Core Sector Equity fund (TCSEF).

Practices of Islamic Banking Systems by Western Banks

The development of Islamic banking and finance has been helped too by the interest of western banks such as ANZ Grindlays, Chase, Citicorp, HSBC and Morgan Stanley have introduced Shariah compliant products and services. The importance of Islamic banking is also evident by the decision of major stock exchanges such as the Dow Jones and FTSE to offer Islamic indices; evidence from the International Association of Islamic Banks suggests that assets managed by those banks have tripled during last four years.

In the United States, the first Vice President of the Federal Reserve Bank calls that “Islamic bankers have been quite ingenious in developing financial transactions that suit their needs: we bank supervisors, too, can be ingenious and will want to work with any of you should you decide that you want to engage in Islamic banking in the United States”.

Most of the large Western financial institutions, following the example of Citibank, have their own Islamic subsidiaries or, at the very least, Islamic "windows" or products aimed at their Islamic clientele. There is now even a Dow Jones Islamic market index.

Professor Rodney Wilson aptly remarked, “It is an excellent reflection of the success of Islamic banking that many conventional commercial banks are now offering their clients Islamic financial services”. In USA several groups of bankers are practicing Islamic system with a better result. Concerning the application of Islamic banking principles in America. Ken in his article Islamic banking: faith and creativity, notes ‘Islamic banking is making inroads in America as several groups of bankers and Muslim scholars

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attempt to create an interest-free banking system that uses lease agreements, mutual funds, and other methods to avoid interest payments.\footnote{Ken, B., ‘Islamic Banking: Faith and Creativity. New York Times, Late New York Edition. D1 – Apr 8 1994, p. 1.}

HSBC has launched its HSBC Amanah Finance division, focusing on Islamic financial products. There are also western based, but exclusively Muslim financial institutions such as the United Kingdom based, Ummah Finance Group, which offers an Islamic Unit Trust and the Kleinworth Benson Islamic Unit Trust which is based in Jersey\footnote{Rodney Wilson, (Ed.), Islamic Financial Market, Rutledge, 1990, p. 29.}. Murabahah or cost-plus financing transactions have earned Kleinworth Benson $4 billion in 1992, while ANZ Grindlays earned $400 million. The banks arrange for transactions within the limits set by the Islamic banks and get it approved by the Shariah advisors of investors or by banks engaged in the transactions.\footnote{Parker, M., ‘Getting the message across: Islamic banking gets recognized by the Western banks’. The Middle East, October. 1993 no., 227, p. 28.}

These institutions have mostly adopted the pattern of Islamic banking in cost-plus financing, leasing and equity financing for their clients in the Middle East. Southeast Asia and a few international corporations in Europe and Latin America. More recently Switzerland’s UBS has announced to start Islamic banking activities. However, some of the Islamic economists are apprehensive about the sincerity of these multinational financial institutions as far the commitment towards cause is concern. Three senior economists at IDB including the chief of research division at IRTI are of the view that the modus operandi of these institutions is purely commercial. They are of the opinion that these conventional banks may not follow correctly and faithfully the percepts of Islamic banking. “In all major Islamic banks, there is a Shariah board, which regularly reviews the operations and contract of the bank to determine their compliance with the requirements of the Shariah. Similar arrangements do not exist at the conventional Western banks in most of the cases. It is also suspected that conventional banks may not be able to keep fully separate...
accounts for their Islamic banking operations. In the event they do mix “Islamic money” with their general pool of investible resources or they do not keep separate accounts for Islamic banking activities, there is a strong possibility that permissible returns may be ‘contaminated’ by *riba*.”

**Selected Islamic Banking Institutions**

**Islamic Development Bank (IDB)**

The landmark development in the practice of Islamic banking was the establishment of Islamic Development Bank (IDB) in Saudi Arabia in the year 1975. It was the first intergovernmental effort of Muslim countries with the purpose of fostering economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shariah*. The present membership of the bank consists of 52 countries. The authorized capital of the bank is 6 billion Islamic Dinar (Each Islamic Dinar being equal to one Special Drawing Right SDR of I.M.F.). Its subscribed capital is Islamic Dinar 4.1 billion, whereas the paid up capital amounted to about Islamic Dinar 2.5 billion. The ordinary resources of the Bank consist of members’ subscription (paid up capital, reserves and retained profit), which amounted at the end of April 2000 to Islamic Dinar 3.5 billion (US $ 4.8 billion). Unlike conventional banks the IDB has developed new *Shariah* compliant financial schemes and instruments to support its ordinary financial resources. These instruments and schemes are IDB Unit Investment Fund (IDB UIF), the Export Financing Schemes (EFS) formerly known as the Longer-term Trade Financing Scheme (LTTF) and Islamic Banks’ Portfolio (IBP).

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73 Ibid.
Unit Investment Fund (UIF); this is a credit fund started in 1990 with the aim of contributing to the economic development of the member countries through pooling of the savings of institutional and individual investors. Investments in the Fund are restricted to Islamic banks, financial institutions, pension funds, charitable organizations and similar institutions.

The Export Financing Schemes (EFS); started in 1987 under the name The Longer-term Trade Financing Scheme (LTTF) with the aim of expanding the Banks’ operation in the field of trade financing to facilitate the export of member countries’ commodities.

Islamic Banks’ Portfolio (IBP) for Investment and Development: an income fund started with the cooperation of other Islamic banks in 1987. The IDB manages the portfolio in its capacity as Mudarib.

In addition to the above, other programmes of the IDB includes; Import Trade Financing Operations, Export Financing Schemes and assistance and grants to Muslim communities in non-member countries.

In pursuance of its objectives the IDB resort to the following activities:
1. Participate in the equity capital of productive project and enterprises in the member countries.
2. Invest in social infrastructure projects in member countries by way of participation or other financial arrangements.
3. Make loans to the private and public sector for financing of productive projects enterprises and programmes in member countries.
4. Establish and operate special funds for specific purposes including assistance to Muslim communities in non-member countries.
5. Operate trusts funds.
6. Undertake research to enable the economic financial and banking activities in Muslim countries to confirm to the Shariah.
Kuwait Finance House (KFH)

Established in 1977 as an Islamic investment bank, operating under special government decree, which recognizes the Islamic nature of the institution. Government of Kuwait played an active role in the establishment of this institution, which subscribed 49% of the paid up capital of the House. It is one of the most successful Islamic commercial bank in the world. KFH has a permanent Al Fatwa and Shariah supervisory authority comprising of three highly respected Islamic religious authorities and Jurists. KFH is the second largest retail bank in Kuwait employing about 1,300 people. It has around 22 branches and a market capitalization of some KD1.75 billion (US$ 5.7 billions) which puts it among the 10 largest banks in Arabic region. All its activities are based on Islamic Law.74

Dar-al-Mal-al-Islami (DMI)

This is one of the two major holding companies controlling a number of Islamic banks throughout the world. Established by Saudi Prince Mohammad bin Faisal with an authorized capital of US $ 1 billion, the DMI is a holding company registered under the laws of Bahamas in 1981. Today DMI operates in 14 different countries through 22 institutions, which include Islamic Investment companies, Islamic banks and Islamic insurance companies. A number of heads of Islamic states, statesmen, leading government personalities and Ulama of the Muslim world became honorary founder of DMI trust. The objective of DMI is to promote the development of an Islamic financial and economic system, through mobilization and utilization of the financial resources and potential of Muslims in accordance with Islamic principles, laws and traditions. DMI resorts to the activities that can be summarized as follows:

1. To undertake financial operations required by Muslims within the framework of principles and percepts of *Shariah*.

2. To implement its various activities through subsidiaries established in Islamic and other countries.

3. To invest funds of Muslims to generate *Halal* profits.

4. To promote and consolidate cooperation among Muslims.

The DMI group consists of following major categories of companies:

**Islamic investment Companies**: Providing opportunities to businessmen and financial institutions to participate in agricultural, commercial, industrial, real estates development and other financial operations in conformity with *Shariah*.

**Massaref Islamic Banks**: Providing a diversified range of modern banking services and facilities based on Islamic principles to meet the need of various kinds of clients.

**Islamic Takaful Companies** (*Islamic Insurance*): Providing both to individuals and institutions, an Islamic alternative to contemporary insurance in accordance with the concept of solidarity and brotherhood for mutual aid and assistance.

**Islamic Business Companies**: Providing channels for utilization DMI funds and its subsidiaries in the fields of trading, industry and services, which are profitable for the investors and beneficial to the *Ummah*.

**Al-Rajhi Group**

A relatively new entrant is another fast growing private Islamic banking group of Saudi Arabia. Once a largest moneychanger in Saudi Arabia has now entered in Islamic banking business. This is functioning under the direct control of the Saudi Arabian Monetary Agency (SAMA), the central monetary agency
of the country. In terms of managed assets and paid up capital the Al-Rajhi Banking and Investment Corporation is by far the largest institution in the country.

**Al-Barakah Group**

Established in 1982 by Saudi Shaikh Saleh Abdullah Kamel, it is among the few largest Islamic banking groups in the world. The group has financial interest in around 50 countries. It has twelve affiliates and financial interests in some other sister institutions. The Al Barkah group covers a wide spectrum of activities including banking, insurance, securities, trade, agriculture, industry, tourism, venture capital, research and training etc. The group aims to achieve the goals of Muslim individuals and communities within the Islamic framework.

**The Islamic International Bank for Investment and Development (IBID)**

A Cairo based IBID was established in 1980 by a ministerial decree in accordance with the investment law of Arab and Foreign Funds Zones law of 1974. It was register with the Central Bank in 1980.

This period is also characterized by another landmark development in the history of Islamic banking when a full fledge governmental effort were noticeable to Islamize the entire economy in Pakistan, Iran and Sudan, which we shall discuss in the following sections.

**Faisal Islamic Banks (FIBS)**

Prince Mohammad bin Faisal of Saudi Arabia founded the Faisal Islamic Banks of Egypt and Sudan in 1977 and 1978 respectively. In Egypt this bank was established by a special Act in which 51 % shareholding was Egyptian and Saudi and other Muslim nationals holding 49%.
In Sudan the concept of Islamic banking was introduced with the establishment of Faisal Islamic Bank in 1978. Its success cleared the way for the establishment of other Islamic banks in the country. The authorized capital of the bank is LS 100 million, of which 40% of each is divided between Saudi and Sudanese shareholders and the rest 20% from other Muslim countries. The banks own five subsidiaries undertaking different economic activities like construction, insurance, agriculture and industry, trade and services and clearance. The bank has a Shariah supervisory board appointed by the General Assembly of the shareholders.

### Jordan Islamic Bank

One of the most respected Islamic banks established by a temporary special law in 1978. It is a public shareholding limited company with an authorized share capital of JD 6 million. This is the third largest bank of the kingdom with more than 40 branches. It constitutes around 9% of the total bank deposits in the country.

Table no. 3.5 gives the assets wise position of Islamic banks during the period 1995-96. Al-Rajhi group is the first among them in all position i.e. assets, capital, profits and staff followed by Kuwait Finance House and Faisal Islamic Bank of Egypt. Some other top most Islamic financial institutions are followed in order.

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Table No. 3.5
Leading Islamic Banks

<table>
<thead>
<tr>
<th>Bank</th>
<th>Assets ($M)</th>
<th>Capital ($M)</th>
<th>Profits ($M)</th>
<th>Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>Al-Rajhi Banking and Investment Corp.</td>
<td>7711</td>
<td>1091</td>
<td>214.1</td>
<td>5823</td>
</tr>
<tr>
<td>Kuwait Finance House</td>
<td>4273</td>
<td>229</td>
<td>130.9</td>
<td>1400</td>
</tr>
<tr>
<td>Faisal Islamic Bank of Egypt</td>
<td>1658</td>
<td>132</td>
<td>72.1</td>
<td>1236</td>
</tr>
<tr>
<td>Faisal Islamic Bank of Bahrain</td>
<td>1542</td>
<td>85</td>
<td>16.1</td>
<td>272</td>
</tr>
<tr>
<td>Dubai Islamic Bank</td>
<td>1527</td>
<td>74</td>
<td>4.6</td>
<td>n.a.</td>
</tr>
<tr>
<td>Qatar Islamic Bank</td>
<td>884</td>
<td>52</td>
<td>8.5</td>
<td>296</td>
</tr>
<tr>
<td>Bank Islam Malaysia</td>
<td>779</td>
<td>80</td>
<td>13.8</td>
<td>895</td>
</tr>
<tr>
<td>Jordan Islamic Bank</td>
<td>750</td>
<td>56</td>
<td>6.1</td>
<td>913</td>
</tr>
<tr>
<td>Dar al-Maal al-Islami (Geneva)</td>
<td>634</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Sudanese Islamic Bank</td>
<td>630</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Faisal Islamic Bank of Sudan</td>
<td>571</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Bahrain Islamic Bank</td>
<td>383</td>
<td>35</td>
<td>3.6</td>
<td>110</td>
</tr>
<tr>
<td>Al-Baraka Investment Bank Bahrain</td>
<td>163</td>
<td>23</td>
<td>4.4</td>
<td>67</td>
</tr>
<tr>
<td>Bahrain Islamic Investment Co.</td>
<td>29</td>
<td>14</td>
<td>0.5</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Wilson Rodney, Islamic Finance, op. cit. p. 28

Conclusion

Modern Islamic banking practices started with the establishment of Mit Ghamr in 1963 have shown tremendous growth and potentials since then. Research works have shown that Islamic banking principles are not only viable but also more efficient and stable than their counterpart conventional banks due to their participatory nature. Islamic banking has established itself as an emerging alternative to interest-based banking and is gaining roots in both Muslim as well as non-Muslim countries.

Several observations of the various international bodies like, World Bank, International Monetary Fund (IMF), International Finance Corporation (IFC), Organization of Economic Cooperation and Development (OECD) have advocated the possibility and viability of the equity based and participating and investment policy of Islamic banks.

In the World Development report 1989 the Islamic banking system is highlighted as under; " Islamic banks offer savers risky open-ended mutual fund certificates instead of fixed-interest deposits. This is not unlike
cooperative banks and mutual funds in the west, where deposits earn variable interest and double as equity. Difficulties arise on the lending side. Arrangements to share profits and losses lead to considerable problems of monitoring and control, especially in lending to small business.77

According to the information provided in the Directory of Islamic Banks and Financial Institutions prepared by the International Union of Islamic Banks, there are 176 Islamic banking institutions in the world out of which 47% are in the South and South East Asia, 27% in Gulf Cooperation Council (GCC) and the Middle East, 20% in Africa and 6% in Western countries. Deposits and total assets of the Islamic banks are US$112.6 billion and US$147.7 billion respectively. Islamic banking is growing at the rate of 10-15% per annum compared with the growth rate of 7% recorded by the global financial services industry.78 Latest available figures suggest that Islamic banking has crossed the $250 billion mark and, in spite of recession in international capital market, growing annually at the rate of 10-15%.

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77 World Development Report, 1989, Box 6.3