ISLAMIC BANKING

An Alternate Approach to Finance

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A.I. Marikar

Dr. A.M.A. Azeez Foundation
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Islamic Banking - An Alternate Approach to Finance

By A.I. Marikar ©

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Foreword

I am very pleased to write this Foreword to the book *Islamic Banking - An Alternate Approach to Finance* by Mr. A.I. Marikar, who played an important role in the formative stage of the growth and development of Islamic Finance in Sri Lanka. He functioned as the Managing Director of Amana Investments Limited from 1997 to 2004, and since his retirement he functions as a consultant in Islamic Finance to many banks and financial institutions, offering his advice and guidance in the opening and management of Islamic windows to these banks and institutions. Mr. Marikar in this book "Islamic Banking – An Alternate Approach to Finance" has brought forth his knowledge and expertise, practice and experience in the field of Islamic Finance, which is very clearly reflected in this work.

Mr. Marikar`s book on Islamic Finance deals with the genesis and the growth of the major principles and ethical norms related to Islamic Banking and also its various products. He traces the emergence of the fundamental principles of Islamic Finance to the very early period of Islam, precisely speaking to the business partnership Prophet Muhammad (PBUH) had with Khadeeja and establishes the fact that all the important principles of Islamic Finance could be observed in this model. As a background to the study on Islamic Finance he discusses extensively the implications of Riba and Islamic disapproval of Riba.

The author traces the history of Islamic Banking in its modern form from its first appearance in 1960. its gradual spread across many countries and its exponential growth worldwide. The author briefly discusses the history of Islamic Banking in Sri Lanka from the time of establishment of Amana Investments Limited in 1997, and its gradual growth culminating in the amendment of the Banking Act in 2005, which legalized Islamic Banking in Sri Lanka.

In this work the author elucidates the concept of Islamic banking within the broader framework of Sharia, and he seeks to remove the misconception about Sharia and place it in the proper perspective with its diverse implications for a Muslim`s individual and social life. The author clarifies the misconceived notions many people have on the compatibility of Sharia with common law, mainly in relation to Islamic Banking. He traces the historical evolution of the common law and establishes the fact that the compilers of the modern law were influenced by the Sharia, to the extent that there is a major area of commonality between the substance of Sharia and the common law of contemporary times.

Mr. Marikar discusses the area of conventional banking and Islamic Banking with major emphasis on perceptions of money in Islam and is functions, issues of interest and the prohibition of Riba.

Against the wider background of conventional banking practice, which is essentially based on Riba or interest he discusses the Islamic model in detail with special emphasis on Islamic products such as Mudharaba, Musharaka, Ijarah, Salam and Istisna and also clarifies the misconceptions about the Mudharaba fund.

The author discusses in detail the attributes of Islamic Finance such as asset based financing, ethical banking based on justice, transparency and fair play, and these are the essential principles according to the author which differentiate Islamic banking from conventional banking.

In the light of the study the author has made on the principles and practices of Islamic Banking, he arrives at the concluding definition about Islamic banking as follows,

"Islamic Banking is Sharia compliant banking based on the same legal principles which govern modern day banking practiced within the contours of transparency, ethics, justice and fair play"

Mr. A.I Marikar deserves credit for producing this work on Islamic Finance, which will be a great source of help to all those who wish to gain a knowledge and understanding about the theoretical and practical aspects of Islamic banking.

Dr. M.A.M. Shukri PhD (Edin)
Director
Jamiah Naleemiah, Beruwela

Preface

The year 1995 was an eventful year in the calendar of Muslim events in Sri Lanka. Just five years before the dawn of the new millennium, Muslims were jolted and the banking community was rattled by the emergence in that year, of an initiative that proposed a system of finance based on Sharia compliant principles.

Some Muslims welcomed the idea with the proverbial tears of joy, some were skeptical because in the long history of banking in Sri Lanka, never before had this idea been mooted and they seriously doubted its survival in the vast financial landscape of conventional Banking. Interest based finance was firmly entrenched in all areas of human activity in the country, and there seemed no chance for any other system to penetrate and carve a presence in what was a very closed conventional Banking industry, with banks wanting to protect their turf at whatever cost.

Necessity however is always the mother of innovation. The year 1995 also saw the emergence of groups of Islamic Banking visionaries, who dared to challenge this status quo and challenge what many felt was the impossible. These pioneering visionaries felt that it would be honorable to try and lose rather than lose without trying at all.

The idea to set up Islamic banking in Sri Lanka was proposed by three groups in Colombo. A serious initiative was proposed by Mr. Osman Kassim, Chairman of the Expo Lanka Group of Companies. The other was proposed by Mr. M.H. Mohamed, the Speaker of Parliament at that time, and the third initiative was proposed by Mr. Rushdi Uvais, Chaiman of the Macky Group of Companies. Extensive discussions were held by these groups to formulate a plan for launching Islamic banking, but the initiative that really picked up traction to move forward steadily was the initiative led by Mr. Osman Kassim.

Mr. Osman Kassim assembled a team of top tier Muslim businessmen, professionals in Accountancy, Law and Banking and a dedicated band of well wishers, and the Islamic banking caravan commenced its ambitious journey in 1995.

Amana Investments Limited was incorporated a short while later and very soon opened its doors for Islamic banking services.

The early days of this journey were quite eventful. There were the expected and unexpected ups and downs, there were moments of agony and moments of ecstasy, moments of pride and moments of despair, but with persistence and tenacity the system gained acceptance not only among mainstream Muslims but also in wider business circles.

As a member of the pioneering team, I feel both honored and humbled for having had the opportunity to contribute and usefully support this initiative. The unquestioned success of Sharia compliant Banking in the country over the last 20 years, is clear testimony that the pioneering efforts have not been in vain.

The inspiration to compile this book came from several pertinent questions that were raised mainly by non Muslim bankers. They were keen to know the reasons for the strict prohibition in Sharia of the use of interest as a pricing tool in finance. They were unsure of the legality of Sharia based contracts and its enforcement through the legal system of this country, which followed common law in the dispensation of justice. They wanted to know whether debt was recognized as a legally enforceable contract and whether security for debts was supported in Sharia. Some even speculated that the entire exercise was conventional finance, dressed up differently with different labels being used to give the process a Sharia flavour.

I hope the above issues and a few other misconceptions have been satisfactorily answered in this small book.

In October 2014, I was invited by the Dr. A.M.A. Azeez Foundation to deliver the Forty First Dr. A.M.A. Azeez Memorial Oration on *Islamic Banking – An Alternate Approach to Finance*. I felt honored as Dr. Azeez was my Principal at Zahira College, Colombo.

Few weeks later, the President of the Dr. A.M.A. Azeez Foundation, Mr. S.H.M. Jameel, my contemporary at Zahira College and the University of Ceylon, and my close friend Mr. Ali Azeez, suggested that I should expand on the subject, and that the book will be published by the Dr. A.M.A. Azeez Foundation. I was encouraged and embarked on the project.

I thank the Dr. A.M.A. Azeez Foundation for publishing the book, and to Dr. M.A.M. Shukri for writing the Foreword of the book.

A.I. Marikar

1

Introduction

Islamic Banking – An Alternate Approach to Finance

Islamic banking as an alternate approach to Banking is sweeping across human societies world-wide with the ferocity of a financial tsunami. Banking circles, Financial regulators and the world of business and finance, initiated a serious dialogue on this emerging Banking initiative only during the last 25 years.

People reacted to this emerging business model in several ways. Some reacted with trepidation, wondering what form, shape and size this model would take. How well it would position itself within an environment of non Islamic legal systems, and what acceptance it will have within the business community both locally and globally, whose framework of practices have evolved very differently over a long period of time.

Some were skeptical and wondered whether this initiative was a manifestation of religious extremism which could plague the island nation with further religious and ethnic anguish.

In the Middle Ages, Middle Eastern traders in the Ottoman Empire and elsewhere practiced financial transactions that were based on Sharia principles. However, it was not until the 1960s and 70s that scholars developed a uniquely Islamic economic philosophy that would address modern economic issues.

Much water has now flowed under the Islamic banking bridge and the mission like the proverbial caravan has moved on from success to success.

The Genesis

It is generally said that Islamic banking made its first appearance in Egypt in the 1960's and evolved slowly from small and humble beginnings in the Arab countries.

As a professional Banker and as a Muslim, I am inclined to trace its genesis quite differently. The fundamental principles of Islamic Finance emerged in the deserts of Arabia approximately a 1450 years ago when two great personalities in history, Muhammed Ibn Abdullah and Lady Kadija, May Allah's mercy be on them both, prototyped the very first working model of a Mudaraba. At this momentous occasion in history, Lady Kadija partnered with Muhammed Ibn Abdullah, may peace be upon them both, and launched a unique business model, with Lady Kadija as Rab Al Maal investing money in a partnership business venture managed by the Mudarib, the experienced caravan trader, Muhammed Ibn Abdullah, may peace be upon them both.

The essential ingredients of Islamic Banking such as asset based finance, the participation of expert fund managers (Mudarib) in a capital backed business venture, the principle that profit/loss sharing in business is a collective right and responsibility, the fusion of capital, enterprise and effort for profit generation, profit instead of interest being used as a performance measure and a pricing tool in financial endeavors despite the wide prevalence at that time of the use of interest as price for money, all these have their genesis in this prototype business model. This business model has continued to be used unchanged for over 1450 years and remains as the bedrock principle of Islamic Banking even today.

In the words of Dr. Dato Dusuki, "Islamic Finance is an old skeleton in a modern dress".

The Landscape

The first Islamic bank was established in Egypt in 1964, but the first to be explicitly based on Sharia principles was created by the Organization of Islamic Countries (OIC) in 1974. Islamic banks continued to proliferate throughout the 80s and 90s and today the Islamic finance market is growing at an average annual rate of 10 – 15% a year – and show no signs of slowing down. Sharia law provides an ethical framework for these financial institutions which emphasizes economic well-being and individual development as well as values such as fairness, honesty, and generosity.

At a global level, Islamic Banking is no longer an embryonic initiative. It has etched a very strong presence in the world of Banking and Finance spreading across many continents from the Americas to the Far East, from Northern Europe to South Africa and in many countries in between. The Gulf countries together with Malaysia took a lead role in transforming the financial landscape by establishing strongly capitalized Islamic Banks in their respective regions. The Accounting and Auditing Organisation for Islamic Financial Institutions in Bahrain, pioneered the setting up of the procedural framework for Islamic Banking by compiling very comprehensive accounting standards and process based Sharia operating Standards. These developments enabled Islamic banks to reach out to client needs globally. The model gradually developed into a clinically precise and well defined operating system, capable of being used under diverse political and economic conditions.

Islamic Banking has grown exponentially world wide. It has touched the USD one and a half trillion mark in incepted business (some estimates place this figure at USD four Trillion) and is reported to be growing at 20% annually. There are over 1000 institutions world wide offering Islamic finance and it has a strong presence in nearly all the major world financial centres.

Coopers estimate the global market capitalization of Islamic trade and finance at USD 21 trillion. To place this figure in perspective its worth pointing out that Global GDP is around USD 25 Trillion. The global market potential for Islamic finance is therefore of colossal proportions.

The Sri Lankan Experience

In Sri Lanka we were quite proactive in accepting, developing and launching Islamic Banking. The first stand alone Islamic financial institution made its debut in 1997 with the setting up of Amana Investments Ltd. and the major milestones in the development of this industry were achieved rapidly within a space of less than 15 years.

The Banking Act was amended in 2005 as a result of which for the first time in the history of Banking in Sri lanka, Islamic Banking was legalized and the Central Bank became responsible for the licensing and regulation of all Islamic Banks and Islamic Finance and Leasing companies. This led to the rapid proliferation of Islamic Banks in the country.

Amana Bank was licensed in 2013 and almost all the major conventional Banks set up Islamic Banking divisions during the following two years including Bank of Ceylon, Peoples Leasing, Commercial Bank, Hatton National Bank, National Development Bank, Seylan Bank and MCB Bank. Many finance companies and leasing companies also set up Islamic Finance divisions. Lanka Orix Leasing Company is a leading player in Islamic finance in the leasing sector.

The potential market size of Islamic Finance in the country is estimated at Rs. 250 Billion of which incepted business by all Islamic financial institutions was around Rs.50 Billion during 2014. These are impressive achievements and the growth surge continues.

The Pioneering Journey

The journey of the Islamic banking initiative in Sri Lanka so far, has not been an easy one. The label 'Islamic' has led many Muslims and non Muslims to think that Islamic Banking is part of the revealed body of faith of the religion of Islam which should concern only the devout Muslim. This system of Sharia compliant Banking after all is based on Quranic law and Sharia compliant Banking they contend is an extension of Islamic religious law. They question both the need, the relevance and applicability of Sharia to modern day banking which is by and large based on Common law.

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Misconceptions

Sharia

This misconception needs to be demystified. Sharia is an Arabic word lexically meaning road or pathway. It is a term used to denote a body of law which is used for the purpose of guiding human society and is essentially legal in nature and content. Broadly speaking Sharia is classified into the five following compartments;

i. Sharia Ibadath
ii. Sharia Kilafath
iii. Sharia Imarath
iv. Sharia Muasharat
v. Sharia Muamalath

From the perspective of religious dogma, hard core Islamic religious doctrine is found almost in its entirety in Sharia Ibadath. Rules relating to religious rituals such as Prayer, Fasting, Zakat (Compulsory charity), Haj and Thawheed are the subject matter of Sharia Ibadath. All the other areas of Sharia are focused on best practices for the survival and existence of a peaceful and healthy human society.

The rules of good governance, the rights and obligations of rulers are the subject matter of Sharia Kilafath.

The rights of the governed, their obligations and their role in society are found in Sharia Imarath.

Rules regarding family matters, rights of children, marriage, divorce, inheritance etc., are elaborated in Sharia Muasharat.

Matters concerning trade, finance and related subjects such as contracts, debt, guarantees, pledge, trusts etc. are comprehensively covered in Sharia Muamalath.

What needs to be emphasized, is that one fifth of Sharia is doctrinal, is about Religious dogma while four fifths of Sharia is about rules for the well being of human society.

Sharia therefore is a body of law, its about jurisprudence, its therefore a legal system.

Islam – A Holistic Religion

Many non Muslims and some "neo liberal" Muslims, quite often wonder why devout Muslims tend to be so overwhelmed by Sharia to the extent of wanting to embrace it in its entirety and apply it to every aspect of their lives. To a devout Muslim, Sharia compliance is not restricted to matters of ritual worship alone. The dress code, food, good manners, interaction with people in society, trade, financial dealings and many more matters, must all exist and pulsate within contours prescribed by Sharia. The reason for this mindset stems from the very purpose and meaning of being a Muslim. Islam means "submission to the will of Allah". The life of a Muslim must therefore reflect and accommodate the totality of Sharia, if he is to truthfully declare that he is submitting his will to Allah. Religious rituals are only one component of such submission, the bigger part of submission is enlightened living for which guidelines are prescribed in Sharia. A Muslim cannot compartmentalize his obligations and selectively follow some and not follow others.

This is in stark contrast to the western philosophy of separating Church and State in the lives of people. "Render unto Caesar that which is Caesar's and render unto God what belongs to God is the credo of this western approach. This categorises human obligations into two water tight compartments. Obligations of a religious nature, are in this mindset, distinct and separate from obligations towards the rest of mankind and state. The two do not comingle. This has profound implications in the day to day life of people.

The following examples epitomize this difference.

- Whilst walking on a pathway, when a devout Muslim notices a piece of broken glass or stone which could hurt another person, its an act of submission to the will of Allah (worship) for him to remove it and put it away safely.
- A devout Muslim who treats his Muslim or non Muslim neighbour, with kindness and deals with him with justice and fairness, is engaged in an act of worship by so doing.
- A devout Muslim who is honest in his speech, sincere in his intensions and charitable in his dealings, is submitting his will to Allah by such behaviour.
- A devout Muslim's perspective of life is therefore creator centric and the all encompassing nature of his life style is what he believes will take him from where he is now, to where he wishes to be especially in the hereafter.

Legal Compatibility

This leads us to the next misconception that many people have on the compatibility of Sharia with Common law especially in the context of Islamic banking.

Historians who researched the evolution and development of common law, hold the view that common law as we know it had its origins in the 17th century in the writings of the eminent Dutch jurist Hugo Grotius (1583-1645). His book 'The laws of war and peace' which he released in 1625 is thought to be the foundation of modern law. Hugo Grotius however never claimed to be the original author of all the legal principles propounded in his writings. These he believed were the laws of mankind which evolved over time. Hugo Grotius drew inspiration from the vast bodies of law that pre existed his time and extracted principles of law and gave them focused expression in his writings.

Hugo Grotius and other eminent jurists of his vintage were strongly influenced by laws that were practiced by early civilizations such as the laws of the Phoenicians (2000 BC), The laws of the Babylonians (500 BC) which saw its high watermark in the compilation of Hamurabis code in 55BC, the laws of the Mesopotamians (1500BC). The laws of the Romans and Greeks (1000BC), the laws of the Assyrians (2000 BC), the laws of the Egyptians (2000 BC) etc. Human societies had flourished for thousands of years under the protective canopy of these legal systems and those laws naturally influenced jurists of a later era.

Hugo Grotius and other early jurists were also strongly influenced by another body of law, which to them was more state of the art, and this was Sharia. It was newer, more comprehensive and addressed the developing needs of societies. Sharia was propounded around 700 AD and unlike the laws of the earlier and older civilizations which were all of the era BC, Sharia was the only body of law belonging to the era AD.

Further, more by the 17th century, Islamic jurists had researched extensively and had written copiously on a very wide spectrum of topics which very strongly influenced Hugo Grotius and other 17th century Jurists. By this time the Islamic libraries in Al Andalus (Spain during the 700 year Muslim rule), Bagdad, Damascus, Cairo, Madina and in a multitude of other Islamic learning centres were replete with a plethora of researched writings on Sharia. The compilers of modern law were not merely overwhelmed by these monumental works but were also strongly influenced by Sharia to the extent that there is a large component of commonality between substance of Sharia and the Common Law of today.

> "Islamic legal learning made a substantial contribution to the sum total of universal legal scholarship"
>
> "Particularly in relation to science, philosophy and jurisprudence, the influence of Islamic scholarship made a great impact on European knowledge"
>
> - G.C. Weeramantry's book *Islamic Jurisprudence*

It would be appropriate at this stage to quote what an eminent non muslim Jurist, Justice Weeramanthry had to say about Sharia. Justice Weeramanthry as you may know is a retired Supreme court judge, a Professor of Law at Monash University and a one time Senior Vice president of the International Court of Justice in the Hague. An erudite scholar who has authored several books on Law and related subjects. In his Book 'Islamic Jurisprudence' he begins the first chapter titled 'Sharia' with the following profound and overpowering words, Quote 'Although the Islamic system of jurisprudence is one of the best developed and most adequate systems in the world, very little is known about it by western law students.' Unquote. When an erudite scholar of Justice Weeramanthry's stature, chooses superlative terms like "best developed" and "most adequate" to describe and pay tribute to Sharia, there is little need for anyone else to say more about it.

When we speak of Sharia based principles we are also talking about common law principles. Both bodies of law are identical in substance and the few differences that may appear to exist are generally on matters linked to ethics and transparency on which Sharia is uncompromisingly stringent.

In summary, Sharia is not entirely religious dogma, it's a body of law which has strongly influenced common law and in substance, common law and Sharia share a large area of commonality.

When we say that Islamic banking is Sharia compliant Banking, what we are really saying is that its based on the same legal principles which govern modern day banking, but practiced within contours of transparency, ethics, justice and fairplay.

Conventional Banking

To comprehend Islamic Banking, one has to understand clearly the areas of divergence of conventional banking and Islamic Banking.

Conventional Banking is debt based Banking. The primary function of a conventional bank is to give loans to clients. People who borrow money from a bank, become in a legal sense, debtors to the Bank and that is their legal status. The debtor has a legal obligation to repay the debt together with Interest and provide, if so requested by the creditor, adequate security for protecting the debt. When banks grant loans, the bank is the creditor and the borrower is the debtor. Many laws have been enacted over time specifying the rights and obligations of creditors and debtors and the right of creditors (especially Banks) for fast tracked recovery of money lent. These are found in numerous debt recovery legislation.

On the side of deposit taking, when a customer deposits money in a current account, a savings account or a deposit account, the Customer is the legal creditor and the Bank is legal debtor. The singular relationship that a conventional bank has with clients is therefore that of a debtor and creditor. Interest paid and received in conventional Banking is in the nature of rent or hire, that is paid for using money, arising from the principle accepted in conventional banking, that money has 'Usufruct'.

Islamic Banking takes a very different route. It centers around the principle that money by itself has no Usufruct and therefore cannot generate a surplus. From an Islamic banking stand point, money can generate a surplus only repeat only, if it is combined with Effort, Enterprise and Risk bearing. This was clearly demonstrated in the business model prototyped by Lady Kadija. Lady Kadija's capital was combined with the 'Effort' and 'Enterprise' of Muhammed Ibn Abdullah (May peace be on them both) and both agreed to share profits and losses. This is the principle of the 'Mudaraba' which is also at the very foundation of Islamic banking.

Loss sharing by all transaction linked stake holders, is a non negotiable principle in Islamic banking and is a significant difference between Islamic Banking and conventional Banking.

In conventional banking, providers of capital (depositors) are not loss sharers and are legally entitled for the guaranteed repayment of capital together with interest. Operating losses are the total responsibility of the Bank.

Perception of Money in Islam

The key difference between Islamic and conventional Banking pivots around the perception by each, of the role and function of money. Conventional banking operates on the principle that money has the characteristics of a physical asset and therefore has commodity dimensions. This theory contends that Money as a physical asset is functionally the same as any other asset such as a house, a car or a machine, and has the ability to produce a "Usufruct". Usufruct in an asset is primarily the service the asset can render for the benefit of the user. A house for instance has the ability to render the service of providing shelter, for the user to live in it in safety and comfort.

If the house has no roof, then the structure has no Usufruct. The physical attributes of such assets therefore play an important role in precipitating the creation of its Usufruct and such attributes must continue to exist during the tenure of the transference of the usufruct. The owner of the asset, therefore, has a perfectly legitimate right to charge a rental when the usufruct of an asset owned by him, is transferred to someone else's use. The same principle applies when a motor vehicle, a machine or any asset in this class, is rented.

In Islamic economics, the perception of money and its functions, are very different from the views held by conventional Banks. In Islamic economics the functions of money are the same as those propounded by economists from the time of Adam Smith to those of today. As all University students in economics world wide are taught even now, money has three functions and only three functions. It's a medium of exchange, a measure of value and a store of value. Let us look at this in detail.

Medium of Exchange

In a world where human needs are diverse and where there is variety and multiplicity in the production of goods and services, the need to exchange becomes paramount. We have moved away from the subsistence type of economy of medieval times to an age of mass production based on specialization. The early mechanisms designed by mankind for exchanging goods were based on the system of Barter where people exchanged goods for goods or services for goods. This system was inefficient and unwieldy and was abandoned even during early times. In place of such a system people found it more efficient to introduce a value based intermediary to facilitate the exchange of goods and services. Money evolved as this intermediary and initially it took the form of Gold and Silver coins (Gold Standard). Value of goods and services were measured in terms of units of currency and this facilitated exchange. An important function of money is therefore to act as a medium of exchange.

Measure of Value

This function of money basically arose out of the need of human societies to exchange goods and services. A common value based denominator was needed to express the value of a commodity or service. Instead of expressing the value of something by relating it to units of another commodity, money evolved as the yardstick and its unit was then given a discernible and universal value. Another function of money is therefore to act as a measure of value.

Store of Value

Surpluses in income require arrangements for savings or storage. For reasons of obsolescence, quality deterioration, demand and supply volatility, it is not viable for surplus production to be stored in their produced form for resale or reuse later. Money emerged as the non perishable denominator of known value to fulfill this role. Thus the third function of money is to be a store of value.

Pure economics then and now, did not give money any function other than the above three functions. Islamic economics has always been consonant with this view.

The Issue of Interest

Owners of money, especially its vendors, however, many hundreds of years ago, started giving money a fourth function. They gave money commodity dimensions and propounded the theory that money is an asset with usufruct. They concluded that money can be bought and sold like any asset and its usufruct can be transferred. By extension therefore they legitimised the charging of interest on loans by stating that this was in the nature of rent for the usufruct in money that was transferred to the debtor.

Islamic jurists and economists dismiss this claim outright. From an Islamic perspective money has no usufruct and there is no justification whatsoever for collecting interest on money lent. This is a settled principle in Sharia which is totally non negotiable.

Islamic economists and Jurists hold the view that money does not have usufruct because it belongs to the class of assets which do not have usufruct, such as Food, Petroleum products, Ammunition, water etc. These are all assets that self extinguish when consumed (used). The material attributes of such assets do not continue to remain in a physical form and its ownership continues only as a legal concept. In the absence of usufruct, there is no justification for charging rental for money given by way of a loan and Sharia therefore treats interest as irrelevant in financial transactions.

Quite apart from this, the overwhelming inspiration for a devout Muslim to abstain from dealing with Interest (Riba) comes from the Islamic scriptures ie. The Quran and the Authentic Hadiths (the traditions of the prophet). Both sources are replete with exhortations urging the devout, to totally abstain from practicing Riba. The tone and the intensity of the prohibition is discernible from the following;

First Principle

When Allah makes a prohibition in the Quran even once, it becomes mandatory for every Muslim to observe such a prohibition without exception. When the pronouncement is repeated in the Quran several times, it becomes manifestly clear that the creator has ranked such a pronouncement as a high priority matter which must be meticulously observed. Non observance of such rulings is tantamount to outright disobedience and is ranked as a serious transgression.

The Quranic prohibition on Riba are found in the Quran in more than six of the following verses:

(i) "Allah permits trade but forbids usurious gain" Quran 2.275

(ii) "Those who consume usury cannot stand on judgment day" Quran 2.275

(iii) "Allah destroys usury" Quran 2.276

(iv) "Fear Allah and relinquish what remains of usury, if you are believers" Quran 2.278

(v) "If you do not, take notice of war from Allah and his apostle" Quran 2.279

(vi) "Ye who believe, devour not usury, doubled and multiplied, but fear Allah that ye may prosper" Quran 3.130

Second Principle

When a pronouncement is made in the Quran by Allah, using words which convey great anger and disgust of those who transgress, Muslims must take serious note of such pronouncements.

In verse 2.279 Allah says "if you do it (ie. Practice Riba) take notice of war from Allah and his Apostle".

Nowhere in the Quran does Allah say that sins are punishable by an act of war by the creator. From the above verse it is clear that the only sin for which Allah says he will wage war, is the sin of practicing Riba.

In a Hadith narrated by Imam Muslim " The messenger of Allah (PBUH) cursed whoever eats of Riba, feeds another with it, writes an agreement involving it or acts as a witness to it".

In another Hadith narrated by the same Imaam, the messenger of Allah (PBUH) said "usurious gain is of seventy kinds, the least of which is as bad as a man marrying his mother".

Usurious Gain is not confined only to money, gold or silver. Usurious gain can be present even in commodity transactions.

In a Hadith narrated by Imam Bukhari in the book of representation, Vol. 3 Hadith no. 499,

> "Narrated Abu Huraira, when a man came from Madina he brought with him dates called Janib. The Prophet asked him "are all dates from Khaibar of this kind? ", the man replied " no, we exchanged two saa's of bad dates with one saa of this kind of dates or exchange three saa's for two". On that the prophet said "that is Riba, don't do so, but sell the inferior quality dates for money, and then buy Janib with that money".

Many reasons can be adduced for the strict Quranic prohibition of Riba. Foremost among these is perhaps the need to protect the poor and the financially weak and those in distress, from the oppressive might of the rich and those who are financially strong. In the Shakespearean narrative, the story of Shylock the money lender and Antonio the borrower epitomizes such oppressive tendencies.

3

Islamic Model

The Islamic Banking Model introduces a paradigm shift to the very thought process of how money can be utilized for profit generation. It rejects the conventional belief that money has usufruct and shuns the practice of borrowing and lending money on interest.

The option it employs is a very simple one. It uses the platform of trade that has been used by mankind for generations. This approach uses the core formula of fusing Capital with effort, enterprise and the sharing of profits or losses in business.

The Lady Kadija business model has shown us the simplicity of this approach. Business and trade as practiced by mankind from very ancient times were always based on the integrals of the Lady Kadija business model. Trade and business, is all about combining Capital with Effort and Enterprise. The result of such an initiative at the end of the venture, is the generation of profit or loss which is shared by the participating entrepreneurs.

The financial re engineering that Islamic Banks therefore need to undertake, is simply to use trade based platforms for the disbursement of money and to build into business processes, standard practices followed by traders and businessmen. Some of the universally used business/trading methods are:

(i) Buying and selling

(ii) Partnership business including and venture capital investments

(iii) Leasing

(iv) Project finance including agriculture finance

An Islamic Murabaha is the platform that Islamic banks use to facilitate the buying and selling needs of traders, Musharaka is partnership finance, Ijara is Sharia compliant leasing, Salam and Istisna are very versatile platforms for financing start up projects and for providing agriculture finance. These modes of finance were not divinely revealed but were designed by mankind to fulfill the needs of traders businessman and society. They were however carefully re engineered to comply with the principles of Sharia and embody the principles of transparency, justice and fair play.

The range of products in Islamic Banking, being man made, is not finite or cast in stone. The product range is in fact endless. The potential for re engineering modalities of Islamic finance is wide and unlimited. Limitations in human ingenuity is what actually determines the horizons of Islamic financial product development.

The Bank as Mudarib

Islamic Banking is a tripartite business process. The three main players in the system are; the providers of Capital (Rab Al Maal). The intermediary funds manager (Mudarib) and the end users of funds, who would be individuals, partnerships or corporate business entities. The central player in the entire process is the Mudarib, the role assigned to the Bank, who assumes the position of Funds manager.

In a modern context, the title of 'Funds Manager' is a very apt description of the Islamic bank's role. The Bank is nothing more and nothing less than a manager of money belonging to outside parties (Investors – Rab Al Maal) which function it performs for a pre agreed share of investment income. The Bank is therefore only an agent of the investors, who have chosen to place money with the Bank for further investment in profit generating business ventures.

The Banks role of agent/ funds manager, gives rise to a relationship in which the bank has clearly defined rights and obligations.

The Banks Rights

(i) The right to pre agree with investors, the ratio of profit sharing of investment income including the frequency of profit sharing.

(ii) The right to be fully indemnified from bearing or sharing genuine investment losses so long as the bank has acted in good faith and has practiced high professional competence in the selection, evaluation and management of investments.

(iii) The unfettered right to manage the investment portfolio without any form of interference from investors, unless the funds being managed have conditions imposed by investors (Restricted Mudaraba) in which case the Funds Manager must mandatorily act within the scope of his authority. For example, if the condition imposed on a restricted Mudaraba is that the funds must be invested in a specified project or sector, such as for instance in shares quoted in the stock exchange, the funds managers authority extends only to investments in quoted shares and nothing else.

Most Mudaraba funds managed by Islamic Banks (as Mudarib) are unrestricted Mudaraba's and contain no restrictions on the types of investments that the Mudarib can choose from. The Mudarib in such cases is able to exercise wide discretion in the selection of investments.

(iv) The right to engage the services of experts or specialists where such specialized expertise is required to enable the Mudarib to make sound and professionally balanced investment decisions in his capacity as Funds manager. The costs incurred for such advisory engagements will be borne by the Mudarib or the RabAl Maal or the clients depending on the circumstances of each case. For example, legal fees paid to a competent lawyer for approving contract documents relating to Mudaraba operations, would be treated as a direct expense and charged to distributable profits. Fees paid to a valuer in real estate transactions would be passed on fully, to the client customer.

(v) The right to comingle his Capital and equity money with those of the Rab Al Maal and make investments from a common funds pool. He also has the right to place such money in a separate fund and invest separately and be entitled to take the entire income accruing from such investments. An important condition that the Mudarib must observe in such cases is to avoid a conflict of interest and to give priority for investments to funds belonging to the Rab Al Maal.

(vi) The right to introduce prudential practices in income distribution and observe other prudential requirements of Industry regulators such as the Central Bank.

This would include specific and general provisioning for non performing investments and the setting up of industry/ product caps as exposure limits. These however require the prior approval of Investors.

(vii) The right to engage in syndicated investments with other Banks and to agree to terms of such participation, so long as such contractual engagements do not at any stage or in any way violate the rules of sharia.

The Banks Obligations

(i) The Bank must exercise utmost care and prudence and practice high professional competence in its role as Mudarib. This requires the Bank to engage the services of efficient and competent Banking professionals and have sufficient staff cadres to discharge its role efficiently at the high standards required in the industry.

(ii) The Bank must recognize the competitive environment in which it has to operate and provide to investors, a return comparable to those being offered in the market.

(iii) The bank must accept that any investment losses arising from fraud, negligence, lack of care, reckless and unprofessional business conduct on its part, could place it in dire straits, and if found culpable of incompetent management, be held responsible for resulting financial losses.

(iv) The Bank must demonstrate professionalism in its operations and ensure compliance with Tax regulations, Regulatory requirements and similar matters and always be adequately capitalized so that no harm can befall the Mudaraba fund.

Penal levies imposed for regulatory non compliance will be the sole responsibility of the Bank.

Investments

This is an area of crucial importance to the Islamic bank. Investments are the only source of income for an Islamic bank and is also an area of high financial risk. Islamic banking is trade based and all investments are therefore participatory. The bank and its customers, are in a sense fellow travelers, who are partners in a common business journey.

This does no mean that the Islamic Bank is given Carte Blanche authority by the owners of the Mudaraba fund, to sail in any unchartered business voyage and incur risks which are avoidable and reckless. The bank is only a professional funds manager and is not the owner of the money in the fund. It is only a prudent and professionally competent investor whose role is to identify, evaluate and manage investments so that good income is generated and the capital invested in the mercantile venture is always protected. This places an onerous responsibility on the shoulders of the bank to ensure that whilst good profits are generated from investments, for sharing with the owners of the fund, the risk of capital loss is also minimized or eliminated from the process. This is not a policy of loss aversion but is a prudent approach of loss avoidance.

This is a reasonable position to take, as loss avoidance is an important consideration of any business venture. If despite all the genuine care and good intensions, the investment results in an income loss or a partial or full capital loss, then such income losses are shared by the Rab Al Maal and the Mudarib and capital losses are absorbed fully by the Mudaraba fund.

It must be noted that an Islamic Bank is not a charitable institution engaged in social welfare and is most definitely not a financial shock absorber obliged to rush to the rescue of loss making badly negotiated business deals of its clients. If people choose to throw business caution to the winds and incur losses, then the consequences of such reckless behaviour is a burden that they themselves must bear.

There is also the serious misconception that the Mudaraba fund has endless capacity to absorb business losses of the clients of the Bank. This is a very erroneous belief. The Mudaraba fund represents the collective endeavor of many poor and ordinary people whose hard earned money form the bulk of any Mudaraba fund. These are devout Muslims who invest their money in the fund, for a Halal return which they desperately need to pay for living expenses. Widows, Orphans, Retirees, Mosques and NGO's engaged in charitable activities and just poor and ordinary middle class people, are some of the major stake holders in the fund. It is the bounden duty of the Islamic Bank to protect the Capital entrusted to them by these very vulnerable segments of society and also ensure that such investors are also given a reasonable return on their money. This is the context within which we must understand the principle of loss avoidance in investments.

4

Modes of Finance

There are several authoritative publications on modes of Islamic finance, authored by erudite scholars which are available world wide today. Mowlana Taqi Usmani's book "Hand book of Islamic Finance " and the Sharia Standards prepared by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI),which is headquartered in Bahrain, are two very useful sources of information on the subject. Those who need to know detailed product descriptions and be familiar with the operating processes of Islamic products and services, are seriously advised to refer to such publications. To repeat such information in this book would be to underestimate the monumental effort that is necessary to accomplish the task. What is useful, is to discuss in this book, some of the difficulties that Banks and users have encountered in recent years, when using the commonly practiced modes of Islamic finance under modern market conditions.

Murabaha

A Murabaha is a cost plus mark up sale on deferred payment terms. When a customer of the bank needs finance to purchase merchandise, The Islamic Bank facilitates by purchasing the goods and immediately selling them to the customer at a price made up of the actual procurement cost plus a profit negotiated and agreed with the customer. A Musawama is the same with the exception that the sale price in a Musawama is quoted as one figure without segmenting it into cost and profit components.

What makes Murabah transactions halal is that the bank or what ever finance Institution that obtains the real ownership of goods or services, it undertakes a certain amount of risk during the process between purchase and sale. “Real ownership” and “existence of risk” are key words that makes any transaction legitimate in Islam (Halal).

Before the customer starts paying for the goods or services Islamic bank must hold 100% ownership of the goods or services. At that point Islamic Bank also holds the responsibility for the goods or services too. After all the payments are done the ownership and responsibility passes on to the customer.

Murabaha is a very commonly used trading method in Islamic Banking today. 50% or more of Investments made by most Islamic banks world wide, are transacted on a Murabaha basis.

The reason for its high preponderance in the portfolios of Islamic Banks are many and the salient ones could be summarized as follows;

(i) From a common law standpoint, this platform provides much comfort to Banks in terms of the ease with which the Bank’s rights and the customers obligations are enforceable through industry practice and if needed via a legal process.

Murabaha trading is very specifically permitted in the Banking Act of Sri Lanka. In the Amendment to the act of 2005, Schedule 11 of the act, (this contains the list of business activities that licensed commercial Banks are permitted to engage in) was enlarged to include Murabaha trading, thus giving Murabaha the same legal legitimacy as conventional bank loans.

Further, the legal parameters of a sale are comprehensively covered in the Sale of Goods act and recovery of money disbursed in a Murabaha, has the advantage of fast tracked recovery through the "Recovery of Loans by Banks "Act and the "Debt Recovery Act", both enacted in 1990.

This is comfort plus to Banks.

(ii) Murabaha is asset based trading and the exit mechanism gets automatically built into the structure. This trading arrangement enables the self liquidation of the Murabaha debt, since the sale proceeds of the merchandise generates the cash flow required to settle the outstanding debt . The participating Bank therefore does not have to rely on other trading cash flows of the customer for settlement of a Murabaha debt. From a recovery perspective, the burden of managing Murabaha receivables by Banks, is considerably easier, as the security that Banks take for Murabaha transactions, is really additional collateral which provide a wider margin of comfort to the Bank. The risk profile is thereby lowered and this advantage is usually not available to the Bank in most other modes of finance.

(iii) Murabaha is generally used for short term roll over funding. A single transaction cycle would generally be for periods of up to three to six months. Because of the fast turn around time, the Bank has a better grip over Murabaha receivables. Signs of cash flow strangulation or general customer delinquency comes to the notice of the Bank, very early so that prompt remedial action can be meaningfully taken before the customers financial condition degenerates into chaos.

(iv) All deferred payment trading leads to the creation of debts. Legally and ethically the Banks can demand from the debtor, security for debts he owes to the bank. Most Murabaha portfolios in Banks are generally fully secured by legally enforceable security.

Concept of Loss Sharing

Murabaha trading is not entirely free of the occurrence of loss and the consequential responsibility of the Mudaraba Fund managed by the Bank, to absorb it. As any trader of merchandise will testify there are many operational risks in the business of buying and selling goods. In a Murabaha, the Bank has to purchase the goods required by the customer, and in the process acquire legal ownership of it, obtain physical or constructive possession, agree a selling price with the customer, make a legally valid offer to the customer to sell, receive a legally valid acceptance of the offer from the customer and finally make physical or constructive delivery. The transfer of the risk of loss on goods, from the Bank to the customer, takes place only after legal delivery is complete.

It is important to remember that all the foregoing steps for a legally valid sale, cannot be accomplished at the blink of an eyelid. It takes time, and even at the best of times this could take a minimum 24 hours to quite often a few days. It is during this interim period that the Bank is most exposed to the risk of loss arising from theft, pilferage, physical damage, destruction by fire, water damage caused by rains or floods, damage caused by riots or civil commotions, quality deterioration of perishable goods, lightening strikes or by any act of God. As legal owner of the goods it is the total responsibility of the Bank to bear the entire loss arising from such risks. The customer's responsibility for any loss, cannot begin until legal delivery is made.

A prudent Bank would protect itself from such risk of loss by obtaining appropriate and adequate Takaful Cover (insurance).

A few vexed issues in Murabaha Trading

(i) A very common problem encountered by banks in Murabaha trading, is the failure on the part of the customer to settle Mudabaha dues on time. All Murabaha contracts have a clearly specified and agreed date for payment. When this does not happen, the Bank, or more specifically the Mudaraba fund, starts incurring losses due to its inability to recycle the money for further reinvestment. In terms of the Murabaha contract, the customer is obliged to repay only the amount of the sale, as the concept of penal charges for delayed payment does not exist in Sharia.

As most Islamic Banking practitioners will testify, these payment delays generally extend up to about five to ten days on most Murabaha transactions. The cumulative impact of this widespread phenomena, can cause significant income loss and detrimentally affect the yield on Mudaraba funds.

When some customers are compelled by cash flow constraints to delay payment for a much longer period, the common proposal they make to the Bank is to either offer an additional payment to the Bank ,as compensation for the delay in settlement or to request a renegotiation of the contract for the purpose of revising the sale price upwards for the additional time that they need to fully settle the dues.

This is a preposterous and blatantly fraudulent response which has no legitimacy whatsoever in Sharia.

A more transparent and prudent safety measure that an Islamic Bank can adopt to overcome this problem, is to build an adequate safety margin into the profit component in order to compensate for such income losses. This formula could continue to be applied during the early stages of the relationship with the customer, until the Bank is able to establish the customers degree of timeliness in the settlement of Murabaha dues. The formula for computing the profit on Murabaha sales to individual customers can be fine tuned thereafter.

(ii) The other controversial issue relates to under invoicing of imported merchandise . This is a common practice among many importers, who want to minimize the impact of very high rates of import duty levied by Customs on some imported goods. The duty rates on such goods can sometimes be as high as 80 to 100 percent.

A typical under invoiced import involves the tacit agreement between the buyer and the seller, to declare on the invoice, the contracted quantity of goods but to state its value at a mutually agreed lower amount. The difference in value is remitted quite often through the informal Money transfer system by the importer, immediately upon signing the contract of sale or prior to shipment of goods.

If the under invoiced arrangement is brought to the notice of the Islamic Bank by the customer at the time he makes the request for Murabaha finance , the Islamic Bank must categorically refuse to participate in the transaction for the following reasons;

(a) The customer by signing the sale agreement and by making advance payment (ie remitting the under invoiced amount) has concluded the contract of sale with the seller and has acquired legal ownership of goods.

When this happens, it not permissible in Sharia for the Bank, to again make a valid sale of the same goods to the customer, as legal ownership of goods now vests with the customer.

(b) Under invoicing is an illegal business practice aimed at denying the state of its rightful revenue. A Bank as a holder of a Banking License granted under the Banking Act, has a moral and a legal obligation not to engage in any illegal activity or be a party to willful deception and cheating, aimed at denying the rights of the state to collect revenue through customs levies.

(c) As a Sharia compliant institution the Islamic bank must uphold the lofty ideals of transparency, truthfulness, justice and fair play in all its dealings. It would be duplicitous on its part to engage in shady business deals whilst claiming to uphold high ethical values.

(iii) Another matter of contention in Murabaha trading, is the procedure adopted by Islamic Banks to procure goods for resale to the customer.

Once the customer hands over to the Bank, the invoice of the goods he requires, it is then up to the Bank to purchase the goods and acquire legal ownership and constructive possession over it prior to resale.

Banks however do not have the infrastructure to deploy its own staff to visit sales places of vendors of goods, and also lack the expertise to make crucial assessments of the quality of goods, in order to ensure that what is being bought is exactly what the customer requires.

The way banks overcame this delicate situation in the past, was to appoint the ordering customer as a special agent, for the specific purpose of purchasing for the Bank, the goods that he would eventually buy from the Bank on Murabaha terms.

This arrangement had the tacit approval of most Sharia scholars.

Subsequent events however began to cast serious doubts on the sincerity of this process. This arrangement opened the door to abuse, since banks were now free to transform the Murabaha vehicle into a normal conventional Banking activity of giving loans to customers to buy whatever they wanted.

This procedure fortunately is now disallowed by AAOIFI (Accounting and Auditing organization for Islamic Financial Institutions) and Islamic Banks are now specifically prohibited from appointing the Murabaha ordering customer as an agent to purchase goods that the customer would eventually want to buy from the bank. (AAOIFI Murabaha Std 3/1/3).

The current practice is for Islamic banks to appoint an employee of the Murabaha ordering customer, as a transaction specific special agent, reporting only to the Bank, to undertake the procurement of goods required by the customer.

Musharaka

Musharaka is the heart and soul of Islamic finance. Sharia Scholars rank it as the Gold Standard of Islamic finance as it embodies the prime virtues of justice, fairness and all the goodness that Sharia endeavors to inculcate in the lives of people when they engage in commercial activity.

Historically *Musharaka* was practiced by Arabs long before the advent of Islam, and is therefore considered by many scholars to be the most authentic form of Islamic contract.

Musharaka is partnership based business in which the Bank and the customer jointly embark on a business venture with a view to sharing profits or losses that the common effort is expected to generate.

This is a very versatile business platform that has plenty of space to accommodate a wide range of commercial activity with fewer Sharia restrictions, so long as the fundamental principles of Sharika (Partnership) rules are observed. Sharia rules on Sharika and the Common Law regulations on Partnerships, have very few areas of difference and the process is often well understood by the business community and Banks. Musharaka based finance is fast gaining populariy, but some Banks distance themselves from it because of its comparatively higher risk profile.

The following are some important rules on Musharaka which must be observed when using this mode of finance;

A – Agreement

The agreement must be in writing in order to avoid conflict, misunderstanding and misinterpretation. The Quran emphasizes the importance of written agreements in Sura 2 verse 282.

The objective of the venture must be clearly stated. During the period of its validity, the parties to the contract enjoy the privilege of altering the terms by mutual agreement, in full or in part, including profit sharing ratios.

B – Capital

It is mandatory for both parties to contribute capital in a Musharaka venture.

This must be in monetary assets. It can include tangible assets for use in the venture to form whole or part of the agreed capital so long as such assets are expressed in monetary terms. Both partners must agree on the composition and value of such non cash capital contribution.

The monetized value of capital contributed must be held in a common pool.

Debt cannot form part of capital.

The ratio of capital contribution can range from 1: 99 to 99: 1.

C – Management

Every partner has a right to manage, but by mutual agreement partners can confer total management responsibility to a designated partner or assign limited responsibility to one partner, where one partners specialist skills are necessary for the successful completion of the project. eg. A participating Bank can assume responsibility for the financial monitoring of the project.

By mutual agreement partners can appoint managers to take charge of the project and pay remuneration which can be treated as a project expense.

D – Profits

The Agreement must contain an unambiguous statement of the profit sharing ratio. The ratio is negotiable but must be mutually agreed prior to the commencement of the venture.

The partners CANNOT fix or agree quantified returns, nor agree to a percentage return on capital. Profit sharing must always be expressed as a ratio.

The loss sharing ratio is NOT negotiable and must always be in proportion to Capital contributed.

Profits must be net of all expenses and can be recognized and distributed only upon completion of the venture. Profits cannot be shared on estimated figures. (AAOIFI std 3/1/5/11).

A sleeping partner cannot share profit at a ratio higher that the ratio of his capital contribution.

Partners can however take advances out of operating cash flows to be settled after profit distribution.

E – Guarantees

One partner CANNOT guarantee the capital of the other based on the principle that losses are the responsibility of all partners.

Partners are agents of one another and are individually liable for losses arising from fraud, negligence, misconduct or breach of contract.

Third parties may provide guarantees to make good the loss of capital of one or all partners (AAOIFI std 3/1/4/3).

F – Maturity

Any partner can withdraw any time from the Musharaka partnership by mutual agreement, unless it is agreed in the contract that premature withdrawal is not permitted.

It is permissible for a partner to buy all or part of the partnership assets as per market value. If there is a total buyout of the share of one of the partners, this will bring the Musharaka venture to a close.

Project finance through Musharaka

The tailor made mechanism for Project Finance in Islamic Banking is Istisna. Most Islamic Banks however, frequently opt to use the Musharaka platform for project finance, perhaps because of its relative simplicity, its lesser reliance on third party contractors and the use of contract documents which are very familiar to banks and customers.

This is a three stage process where each phase is dealt with as an independent transaction. The procedure involves three different transactions, each supported by an independent contract.

The first contract deals with details of the framework of the joint venture Musharaka , the scope of which is to set up the project. All The Integrals of a Musharaka contract must be comprehensively embodied in this contract.

The second contract commences with the completion of the project when the Customer as a Musharaka partner, offers to purchase the Banks share of ownership of project assets. The purchase is usually stretched over period of time which is mutually agreed by the two parties. All the Integrals of a sale valid in Sharia must be observed during this stage. If the sale period is stretched over 10 years for example, the contract will require the customer to buy every month a share amounting to 120th of the Banks share of the total project cost .

The Bank is entitled to take adequate security to cover the risk of non payment of such sales.

The third contract is the Indenture of lease. Until there is a total buy out of all project assets by the customer, the Bank can agree to allow the customer to use the Banks share of project assets for his exclusive use. The indenture of lease permits that arrangement and the customer contractually agrees to pay a periodic rental to the Bank.

The rental has to be on a diminishing scale to reflect the customers increasing ownership of project assets with his progressive acquisition of the Banks share.

The Bank is entitled to take security to cover the risk of non payment of rental under the indenture of lease.

A modern variation of this partnership concept is the joint ownership of company project, or asset which is virtually divided into units to be transferred for a fixed price during a fixed period of time from the financier to the ultimate owner.

For the units not yet owned by the ultimate buyer a rent is due according to the character of the underlying transaction; a rent for a house jointly owned is due for the part not owned yet by the occupier.

From the legal perspective an undertaking like a diminishing musharaka consists of multiple contracts and binding promises:

Ijara

Leasing is a concept that is well understood by many people. It is a very popular method of acquiring assets and most Banks aggressively market asset leasing, because of the strong demand it has both within the business community as well as in the community at large. Another reason for the Bank's fondness to build leasing portfolios is the high return these investments generate and the relatively low default rates on lease receivables experienced in the leasing industry.

What is less popularly known by many people is the difference between Conventional leasing and Ijara.

A conventional lease is also referred to as a financial lease. It is really a loan extended to customers for the purchase of assets with its entire internal engineering pivoting on interest.

An Ijara is also referred to as an operating lease. This is a totally different approach to leasing, and has significant differences in the obligations and responsibilities the lessor has to shoulder under the Ijara contract.

The salient differences are;

(i) The asset must be legally owned and possessed by the lessor and only the 'Usufruct' is transferred. (Usufruct is the service that the asset is capable of delivering to the user). Legal ownership imposes on the owner of the asset a plethora of responsibilities. If a house is given on lease, for example, the lessee is obliged to pay the .lease rental only if there is full and complete availability of the usufruct of the asset. If after a storm, the roof of the house is even partially damaged then the character of the usufruct is impaired, and the lessor is obliged to repair the damage without delay, without imposing any financial burden on the lessee. This is the attribute of true legal ownership. In an Ijara contract the lessor is totally responsible for the preservation of the usufruct of the leased asset during the entire period of validity of the Lease agreement.

In a financial lease, the dimensions of the lessors responsibility are not exactly the same. The lessor Bank takes up the position that it is only the provider of finance for the acquisition of the asset and all steps that needs to be taken to preserve the asset's usufruct, is the total responsibility of the lessee.

There is no strong link between usufruct and the right to collect lease rental in a financial lease.

(ii) In an Ijara, the asset stays within the domain of the legal owner during the entire lease period. All risks arising from damage to the asset are therefore the responsibility of the lessor so long as the damage is caused by factors beyond the control of the lessee. Examples of such damage are, destruction by fire, earthquakes, floods and water damage, lightening strikes, other acts of god, manufacturing defects etc. for which the lessee could not be reasonably expected to take preventive action.

The general market practice for overcoming these risks is to get suitable manufacturers warranties against manufacturing defects and to obtain comprehensive insurance cover against all other risks. The question then arises as to whose responsibility it is to arrange and pay for such Insurance cover.

In an Ijara, total responsibility for this lies with the Lessor while in a financial lease, this is put on the shoulders of the lessee.

If one uses the principle of assigning responsibility for insurance, as a litmus test of true ownership of the asset, then Ijara emerges well ahead of its conventional counterpart.

(iii) During the period of impairment of the usufruct, resulting from events beyond the control of the lessee, the lessee in an ijara, is not obliged to pay rental until the dysfunctional condition of the asset is restored by the lessor, so that the usufruct is made fully available to the lessee .

This is not the practice in a financial lease .

(iv) In an Ijara, if the asset is impaired, totally or partially, due to negligence, carelessness, reckless user behaviour or user abuse of one form or another, the full responsibility for repair or restoration of the asset lies with lessee. In such a situation the lessee is required to execute the repairs at his expense and continue to pay rental even during the period when the asset was not in use.

(v) The lease period in an Ijara commences from the date of physical delivery of the asset to the lessee. It does not start from the date of signing of the ijara contract or the date of disbursement of funds for the purchase of the asset. It also does not start from the date of operational use by the lessee.

In a financial lease, the lease period starts from the date of disbursement of funds.

(vi) The lease rental in an Ijara must be mutually agreed and cannot be unilaterally changed by either the lessor or the lessee. Rental can be in cash or kind, can be in the form of a lump sum payment or payment in installments, can be fixed or variable. If its variable, benchmarks can be agreed. It is permissible to mutually agree on different rentals for different periods and percentage increases are allowed for subsequent periods.

This flexibility is generally not available in a financial lease.

(vii) Penalties for delayed payment are strictly disallowed in Ijara. It is also not allowed for the lessor to increase the rental or to stipulate such a condition in the agreement as penalty for delayed payments.

Penalties for delayed payment in a financial lease, are treated as inalienable rights of the lessor and form an integral part of all finance lease agreements.

If there is undue delay in the payment of rental, the lessor in an Ijara has the right to demand full payment of all remaining rentals and enforce any security he may have taken to secure rental payments so as to recover in full the owed amount.

(for detailed guidance, readers are advised to refer to AAOIFI standards on Ijara)

Salam

Salam is a vehicle for extending working capital to agriculture and to industrial enterprises. This is a 1450 year method of working capital finance which was widely practiced in Madina during the life time of the prophet of Allah. This business model therefore has the validation and approval of the prophet and ranks high as a very Sharia compliant product.

1 - The Method

Salam is a forward sale of commodities by the producer. The buyer who is the provider of working capital, agrees a price in advance with the producer at the time of signing a preproduction contract. This is a forward sale of goods by the producer where delivery is postponed to an agreed future date. The purchase consideration is paid immediately to the seller upon signing the contract of Salam.

By contrast, a Murabaha is a spot sale of goods on immediate delivery terms, where payment is deferred, whilst in Salam, cash is paid in advance for delivery of goods on deferred terms.

Sharia has allowed the deferred delivery of goods or services, against spot payment, only in respect of Salam and Istisna sales. These are the only two instances where permission is given for forward sales.

2 – Type of goods

Salam can be used only for goods that are normally available in the market whose quality and quantity can be precisely specified, eg; Agricultural goods, Manufactured goods and Fungibles (goods which can be weighed, measured or counted). eg; food grain, manufactured garments, petroleum products, agricultural produce, chemical fertilizers etc. The quality of goods must be clearly specified without ambiguity.

3 – Salam price

The buyer and seller can agree on any price, and it is permissible for the Salam price to be lower than the spot price in the market for similar goods.

4 – Delivery

The date of delivery of goods must be clearly specified and agreed in the contract, a margin of tolerance is permitted for slight delays. Delivery is required to be made on or very close to the date agreed, of goods which must be of the agreed specification, the agreed quantity and at the place of agreed delivery.

If goods are of superior quality, the buyer must accept and the seller cannot ask for a higher price. If the goods are of inferior quality, the buyer can reject or accept it at a discounted price.

If the seller is unable to make proper delivery, the buyer can grant more time, if that is what the seller needs, or ask for replacement goods which the seller must procure from the market or cancel the contract and demand repayment of the capital that was advanced.

5 – Security

Security can be taken by the buyer to guard against the risk of non delivery or unsatisfactory delivery by the seller.

6 – Parallel Salam contracts

It is permissible for the seller (the debtor in the Salam contract) to enter into a separate and independent contract with a third party to acquire goods of a similar specification. The seller in the first Salam then becomes the buyer in the second Salam.

It is also permissible for the buyer to enter into a separate and independent contract with a third party to sell the goods. The buyer in the first Salam then becomes the seller in the second Salam.

5

Attributes of Islamic Finance

A major attribute of Islamic Banking which differentiates it from Conventional Banking, is the asset based nature of each and every transaction. Sharia injunctions require that financial transactions be accompanied by an underlying productive activity. Islamic banking is asset based financing and is therefore trade based, this means that such an approach must have an asset at its core and it must be the sole rationale for the transaction. The asset must be tangible and must useful to human society. By extension therefore, Islamic Banks define their role as funds managers entrusted with the task of garnering surplus /unutilized public funds and channeling it to useful commercial activities for the betterment of human society.

A conventional Bank on the other hand has debt at its epicenter, instead of an asset. The main focus of a conventional Bank is to disburse loans and to recover them and to levy interest for hiring out money.

Let me illustrate this difference with an excellent example. We have all heard about "Derivatives", which many of us think is a very sophisticated Financial instrument marketed by "Big High Street" Banks and financial institutions. It is projected as state of the art and is proudly proclaimed as a universally accepted panacea for many of our financial woes. A derivative as the name implies, is an instrument 'derived ' from another transaction, and is therefore not a stand alone commercial deal. It is a parasitic instrument totally lacking any tangible substance. The market hype created by the vendors of this instrument has been so powerful, that its market presence today is in the region of USD 600 Trillion. This financial behemoth, devoid of an asset base or any tangible commercial use is paper monster, for the simple reason that Global GDP by comparison is only a miniscule USD 25 Trillion.

The USD 600 Trillion in derivatives represents nothing on planet earth. Derivatives are essentially speculative and the word that we commonly use for describing such activity is 'Gambling'.

Islamic Jurists have declared derivatives a Haram investment. In addition to the total absence of an asset base, derivatives also suffer from other multiple Sharia prohibitions such as Maisir (gambling) and Garrar (uncertainty).

The dangers of using financial instruments which do not have an asset base, especially those which are speculative in nature, such as derivatives, were clearly shown in the recent global financial market melt down . It demonstrated very cruelly that asset less toxic financial instruments can bring about the collapse not only of giants in Banking and Insurance such as Bear Stearns, Lehman Brothers, Freddie Mac and Fannie Mae, Merrill Lynch, AIG, Washington Mutual and many more, but can ruin the economies of countries and bring them to the brink of insolvency. Portugal, Ireland, Greece, Spain and Iceland are some of the countries that had to pay a painful price and were left with no option but to go cap in Hand to outside financial institutions to beg for financial mercy.

Asset based Banking on the other hand provides stability to financial institutions and to Nations, even at times when financial shock waves threaten to crush everything on its path as it makes landfall.

During the financial meltdown in 2008, Islamic Financial institutions remained resilient. According to the Dow Jones Islamic Market financial index, which measures the performance of around 70 Sharia compliant stock markets around the world, the index lost just 2.7% in September 2008, whilst at this time conventional stock markets witnessed a 20% drop in value, with wall Street crumbling into meltdown.

During the Asian financial crisis of 1997 the Islamic financial system performed better than its conventional counterpart and witnessed a growth spurt after the crisis, with large segments of the population migrating to Islamic banking because of its relative stability.

Another attribute of Islamic banking is well expressed in the common tag it carries.

Islamic banking carries the label 'Ethical Banking'. The Intrinsic nature of Sharia compliance in financial dealings requires banks to follow principles which define what is good for society, true, fair, just, and uphold the spirit of ethical benevolence in business and corporate responsibilities, Priority is given to the well being of society.

If we look at Banks, Financial Institutions and Businesses anywhere in the world, we observe that the profit motive is the crux of their business philosophy and the goal of their mission. Success or failure, the quality of performance of businesses are measured by only one yard stick, and that is the size of profits they make. Targets for institutions and key management officials are anchored on profit growth, asset growth, low non performing loans and advances etc. The only condition that they observe is to be on the right side of the law whilst being engaged on this profit maximization journey. Ethical considerations do not really mean a thing to those who embark on this mission.

Let us look at a simple example. Tobacco based businesses are some of the most profitable enterprises in the world today. They record extremely high profits year after year, enjoy very strong and impressive cash flows and are ranked 'Blue chip' among the 'Blue chips' by most rating standards. They use the vast amounts of cash at their disposal to build big and flashy offices, sponsor public events and advertise heavily in prestigious news media in order to impress Banks, movers and shakers in the Business world and the gullible public. Banks in turn Invest heavily to impress cash cows like tobacco businesses. The interest of the two dovetail because both are in pursuit of the same goal, ie profits, which tobacco companies make in abundance. While this symbiotic love affair blooms, we also learn from the small print in news papers that millions of people die every year from tobacco related diseases, millions are in hospitals dying of tobacco related illnesses, and medical researchers are repeatedly saying very unequivocally that tobacco use kills humans. Governments know about the dangers of this addictive drug but remain silent because of the huge tax collections they make from tobacco sales.

Human life, in short, is sacrificed at the alter of money. Ethical considerations are jettisoned in the race for profit maximization.

Islamic Banks are ethically driven because they do not entertain or support businesses whose core activity is harmful to human beings or to society. They believe that business engagements that generate profits must be from ethically supportable sources .Islamic banks therefore do not deal with Tobacco companies, Alcohol companies, Casinos, Lotteries, prohibited food processing companies, and speculative financial instruments such as Derivatives. These businesses generate huge profits but from an Islamic banking perspective they must remain outside the scope of their business for ethical reasons.

Islamic Banks, unlike conventional lending institutions, draw the ethical red line in business engagements, the Rubicon that they will never ever cross.

Another aspect of ethics is Transparency, Justice and Fair Play that Islamic Banks are required to practice in their dealings with customers. The message of Islamic Finance is very clear. Money can be earned and must be earned, but in a manner that conforms to the principles of Sincerity, Justice and Fairness as deeply inscribed in Sharia.

Another attribute of Islamic Banking is its uncompromising commitment to the principle of sharing Risks and Rewards in business.

The stated objective of all Conventional Banks is risk aversion. This policy is legitimate when we consider the fact that Conventional Banks grant loans and by all legal and ethical standards, a debtor is required to repay his debts. The creditor has full legal and ethical rights to recover loans given by him, using a plethora of laws enacted by legislative bodies to assist creditors in the speedy recovery of loans given by them.

By definition therefore, the question of conventional Banks bearing or sharing risks and losses arising from business engagements with clients, does not arise, for the simple reason that their involvement in business activities of their clients is restricted to extending loans and recovering monies lent.

The approach taken by Islamic Banks when establishing a relationship with clients, is fundamentally different from that of conventional Banks. Islamic banks do not give loans and the dealings they have with clients are all trade and business based. This stems from the very different way in which an Islamic bank is constituted. In Islamic Banking the relationship with clients is tripartite. There is the first party of funds providers (Rab Al Maal) who are the equivalent of depositors in conventional Banking. The monies they deposit in the Bank are in the nature of funds given by the first party to the second Party (Mudarib) the Bank, for investment by the Bank in profitable business ventures owned and managed by third parties. Investments are made by the first party, on a profit and loss sharing basis. What this means in practical terms is that, profits on business investments are shared by the bank and investors on a pre agreed basis but losses become the total responsibility of the first party. This is the loss sharing nature of Islamic Banking .Capital losses are borne in its entirety by the first party (Rab Al Maal) and the Bank as Mudarib has to share the loss by not receiving any compensation for its efforts in cases where investments generate a loss.

In stark contrast, the loss bearing responsibility in conventional Banking never lies with depositors and always falls on the Bank.

One must not harbour the impression that Depositors (Rab Al Maal) in Islamic banking are a hapless group, who are forced by the system, to absorb all losses resulting from genuine or negligent/reckless business initiatives chosen for funding by the Bank as Mudarib.

Where negligence, fraud or reckless behaviour by the Bank as Mudarib, is evident and can be established in instances where investments generate a loss, the responsibility for bearing the full loss will fall fairly and squarely on the Bank.

Further more, only genuine losses arising from investments made on a Musharaka (Partnership) platform are borne by investors. Investments made on a trading platform such as deferred payment sales (Murabaha / Musawama) should not technically generate a loss for the reason that trade receivables can be collateralized in Sharia. Payment default, can under this arrangement, be automatically settled by encashment of security given by the client. If the Bank, as a trusted funds manger, fails to obtain appropriate, adequate and encashable security in respect of trade receivables, it will only be exposing itself to great financial risk and danger in the event of non settlement of dues by the client.

The same principle would also apply to Working capital advances (Salam) where the receivable is in the form of commodities.

Another attribute of Islamic Banking is the very different philosophy it adopts when money is used in business engagements. Its an approach which mandates that capital is only one factor of production and that business endeavors must embody the fusion of all factors of production such as Capital, effort, enterprise and sharing the resulting risks and rewards. This formula is recognized in Islamic banking as the only legitimate means of generating income on Capital. Money by itself cannot create a surplus and the conventional explanation that money has the capacity to generate income by itself by renting the usufruct in money , is totally rejected in Islamic banking.

6

Sharia Compliance – Some Disputed Issues

There is concern among some devout Muslims that some of the practices adopted by modern day Islamic Banks may not be consistent with a strict interpretation of the rules of Sharia.

They point out that Islamic Banks quite often tend to follow business practices of conventional banks ignoring some crucial principles of Islamic jurisprudence. It is often said by such people that Islamic Banks resort to the mere use of Islamic terminology in contract documents and then completely ignore the spirit of justice, fair play, transparency and Sharia compliance in their business dealings. They accuse Islamic Banks of not observing the sincere Niyah (intension) of Sharia compliance in business processes.

The commonly used idiom 'No smoke without fire' perhaps has some relevance here. These accusations may be true of some Islamic Banks and partially true of some others, but to throw such a Blanket accusation against all Islamic banks and all Islamic transactions is also unjust and unfair. This is especially so because, from a sharia compliance perspective, all Islamic Banks operate under the guidance of a panel of erudite sharia scholars who monitor the business activities through periodic Sharia audits.

This to a very large extent eliminates any possibility of Sharia infringements that may knowingly or unknowingly infiltrate the delivery process of the Banking service.

The difference between compliance and non compliance, really hinges almost entirely on 'intension' (Niyah). As users of the service, we are obliged to examine, verify and question where necessary, the structuring of the Islamic banking product for Sharia compliance. If the packaging is in all respects Sharia compliant and if the institution has the safeguard of a Sharia supervisory Board, then the intension of the service provider is something that users, cannot and ought not legitimately question.

The following practices are frequently pointed out by some people as being Islamically offensive which they feel should be avoided.

Credit Sales

There is serious criticism of the widespread use of Murabaha and Musawama modes of finance by Islamic Banks. Under this trading platform, the Islamic Bank purchases goods or commodities required by its client and sells them to the client after adding a mutually agreed profit. The sale is concluded on deferred payment terms and repayment is generally stretched over a period of 3 to 6 months.

The criticism is based on the belief that these modes of finance are very similar to loans given by conventional banks. The allegation imputes dishonest intension on the part of the Bank on the basis that they are not really engaged in sales but only package the transaction to make it appear to look like one. They say that a true seller must have stores or warehouses to stock the goods prior to sale, and in the absence of such arrangements on the part of the Islamic Bank, the Murabaha sale is not genuine.

This is not a valid criticism for the following reasons;

(i) With the huge strides that technology has made in modern times, to the way in which people communicate with one another, a colossal volume of trade both domestically and internationally is made via the internet. In many such commercial deals the goods being transacted rarely ever reach the shores of the sellers country. Merchandise is bought overseas and sold to overseas buyers via the internet. This has rendered irrelevant the older concept that the seller must have physical control over goods that he wishes to sell. This is the old warehouse concept. Internet sales however are based on 'constructive possession' rather than 'physical possession' of goods. Constructive possession is a legal way of acquiring possession by exchanging contract documents such as those generated via the internet. This is a legally recognized method of acquiring the right of ownership and possession.

Physical possession of goods is therefore not a precondition for a seller to make a valid sale .Islamic Banks use the principle of 'constructive possession, of the goods they sell in Murabaha and Musawama trading.

(ii) A Murabaha to qualify as a fully Sharia compliant Sale, must satisfy all the requirements of an Islamically acceptable sale. If all the required conditions are met in a Murabaha sale transaction, then there is no justification whatsoever to reject it as being un Islamic. A valid sale in Sharia must embody the following integrals.

- The goods must exist
- The goods must be Islamically saleable
- The seller must have legal ownership
- The seller must have physical or constructive possession
- The price must be quoted and the terms of the sale must be communicated
- The seller must make an offer to sell
- The buyer must accept the offer
- Delivery must take place Physically or constructively

Once these integrals are adequately met in a sale transaction, then such a sale has satisfied all Sharia requirements and from a Sharia perspective it is a valid sale.

Islamic Banks documentarily build into the Murabaha transaction process, all the above steps in order to comply with Sharia and thus make the sale transparently valid.

Let us also remember what Allah says in the Quran

> "That is because they say 'trade is like usury', but god has permitted trade and forbidden usury"(2.275).

What Allah has legitimized and validated in the Quran is therefore not within human jurisdiction to invalidate

Debt Portfolios

Another criticism leveled against Islamic banks is the debt portfolios they carry in their books resulting from Murabaha, Musawama, Istisna (project finance), Salam (Working capital), Ijara (Leasing) and sometimes Diminishing Musharaka (Housing Finance) transactions. These debt items are accused of being tainted with a conventional Banking flavor on the presumption that debts are offensive in Islam.

All Islamic modes of finance create debt receivables, such as rental due on a lease (Ijara)) or the post harvest or post production delivery of agricultural produce or goods under a Salam contract .In a legal sense, these receivables are debt liabilities and are an integral part of any business deal, Islamic or otherwise. In fact Salam was practiced widely for agriculture finance during the lifetime of the Prophet of Allah (May peace be upon him) and he never objected to any of its integrals including the contracted debt liability of the cultivator to deliver on the forward sale of his harvest, to the financier of Salam.

This is therefore a reckless criticism. Nowhere in Islamic scriptures do we find condemnation of debt as an offensive practice. Muslims are definitely cautioned in "prophetic traditions" of the dangers of debt. Casual debt, debts incurred for frivolous purposes, debts taken for maintaining opulent life styles and debts of this class are clearly discouraged in Sharia, but they are not forbidden.

In fact there is there is clear evidence in authentic Hadith, that the prophet himself entered into debt contracts. In Sahih Al Bukhari vol.3 in the book of sales, chapter 15, Hadith no. 282 reports as follows:

> "Narrated Aisha (May Allah be pleased with her), the prophet (PBUH) purchased food grain from a Jew on credit and mortgaged his body armour to him."

This Hadith proves beyond doubt that debts are permissible in Islam.

Security for Debts

The taking of security for debts, by Islamic banks, frequently comes under criticism on the basis that Islamic banking must be trust based and that all Islamic modes of finance must be on the basis that losses are to be shared. The contention is that the taking of security has no relevance in Islamic Banking since equal loss sharing by all stakeholders is an inviolable principle in Islamic finance. Those who support this line of thinking perhaps take up the position that even in modes of Islamic Finance which generate receivables,. the risk of capital loss arising from non payment by the debtor ought to be part of the loss bearing arrangement.

This is a very erroneous interpretation of Islamic guidelines on debt.

A Careful reading of several Authentic Hadiths on debt make it manifestly clear that securing a debt is most encouraged in Sharia. The following authentic Prophetic traditions shed light on this issue.

In Sahih Al Bukhari, vol., 3, in the Book of sales, Chapter 15, hadith no.282, reports as follows:

> "Narrated Aisha (May Allah be pleased with her), the prophet (PBUH) purchased grain from a Jew on credit, and mortgaged his iron armour to him."

In the same chapter, Hadith no. 283 reports as follows:

> "Narrated Qatada, Anas (RA) went to the prophet (PBUH) with Barley bread with some dissolved fat on it to the prophet (PBUH), and he had mortgaged his iron armour to a Jew in Madina and took from him Barley for the family."

This hadith has profound commercial significance with direct relevance to the matter under discussion.

Firstly, The prophet of Allah purchased barley on credit. By so doing he clearly demonstrated that business dealings on credit terms, are clearly permissible in Islam. He obviously purchased on credit without any qualms despite the option he had of borrowing grain or money either from the Baithul Maal (Treasury) or from his numerous companions who would have felt honored to comply with such a request.

He obviously chose the easy and least troublesome option of buying the Barley on credit from a merchant nearby.

Secondly, He provided security by pledging his iron Armour to the creditor.

Let us for a moment reflect on the events that took place immediately prior to this incident. The prophet of Allah who always led a very frugal and simple life, needed food for the evening meal and he knew that there were no provisions left in his larder. He also did not have any money with him to buy even a small quantity of grain. Before stepping out of his house to bring grain for the evening meal, he knew that the purchase of grain will have to be on credit. He therefore prepared himself for the credit purchase and despite the fact that it was a relatively small transaction, he nevertheless took his very valuable Iron armour with the intention of pledging it as security for the very small debt that he was about to incur.

Let us also look at the broader implications of this incident. The prophet at this time was the head of a fast expanding Islamic state, he was the commander in chief of a powerful Islamic army that had emerged victorious in several defensive battles, he was the widely acknowledged and proudly proclaimed prophet of God by the multitude of Muslim followers, he was the head of the Islamic treasury and a person held in very high esteem by those living in Makkah and Madina, including the nobility, and also by many non Muslims including foreign non Muslim dignitaries.

This is the profile of the person who went the Jewish merchant to buy a small quantity of grain on credit.

Asking for security on the credit sale, would have been the last concern in the mind of the Jewish trader, when he was confronted with the situation of having to take the risk of a small debt exposure on a illustrious personality. It is extremely unlikely that the Jewish merchant asked for any security at all. The most plausible explanation is that the prophet of God (PBUH) voluntarily provided security in order to give comfort to the creditor and at the same time to protect himself from the sin of non settlement of a debt should death intervene prior to payment.

Giving security for debts, far from being offensive, is perhaps a virtuous and recommended practice in Islam, as evidenced by this Hadith.

To every Muslim, the prophet of Allah is a role model and when this role model lays down a dignified standard very consciously, it becomes incumbent on us to follow the standard to the letter and in spirit.

Let us pause for a moment and contemplate the practice common among many Muslims of today, when they enter into contracts of debt. The tendency is to negotiate the debt on a clean and unsecured basis especially in cases where the borrower has strong commercial reputation and influence. The prime objective is to obtain the loan facility on a totally unsecured basis and if the creditor pressurizes forcefully, then they relent by giving the least possible. The worst reaction is seen when the debt is not settled and the creditor initiates moves to dispose the security in order to recover the money lent.

When confronted with such a situation most people hire clever lawyers and try every means possible to obstruct and delay the process of foreclosure hoping to halt the secured creditors legitimate attempts to encash the security in order to recover the money lent.

This is the very anti thesis of what the prophet of Allah preached and practiced.

It is sad to note that on matters of debt, many Muslims treat the noble precepts of the prophet with open disdain, disrespect and with no fear of the creators disgust and his threat of punitive consequences for those who transgress. Perhaps they think that death will not reach them one day and that the day of reckoning is only a nebulous and distant concept which need not be taken too seriously.

Another common criticism leveled against Islamic Banks is the non availability of overdraft facilities on customer current accounts. The practice of overdrawing current accounts is so widespread in the Banking industry and also very common among many Muslims to the extent that Muslims tend to equate a Banking relationship without overdraft facilities as being akin to breathing air with depleted oxygen.

For a proper Sharia response on this matter it is useful to examine the definition of an overdraft. An Overdraft is a short term loan given by a Bank that is repayable on demand, on which interest is charged at the end of each month on the total sum of money borrowed. It is not trade linked nor is it part of a profit sharing business endeavour. This is therefore a perfectly good example of a business transaction which has all the attributes of unadulterated Riba.

Overdrafts violate every fundamental principle of Islamic Banking and no amount of cosmetic re engineering or relabelling, can make this unwholesome and un Islamic practice look good in Sharia. It is very pernicious and must forever remain outside the domain of Sharia.

Overdrafts are casual debts which are condemned in Sharia. Those requiring convenient access to cash on a day to day basis, ought to plan trade related payables and receivables so that a reliable cash flow budget is built into the business process. This should generate cash to meet short term operating needs. Sharia compliance in business matters require financial discipline and non Sharia compliant cosmetic short cuts cannot create short term solutions to cash flow issues in an Islamic system.

Overdrafts are also frequently used as supplementary working capital. This practice entrenches its use in business and makes it a permanent toxic item in business balance sheets. Working capital should be available in all adequately capitalized businesses through their normal trading cash flows, if more working capital is required to meet business expansion, it must come from retained earnings or by an infusion of fresh capital. Overdrafts are a dangerous short term fix.

A valid criticism leveled against Islamic Banks in general, is the absence of a properly structured Qard Hassan scheme to assist poor people in distress. All Islamic banks must treat this as a high priority act of social responsibility, especially in developing countries like Sri Lanka where poverty alleviation is a publicly announced goal of the government. We have very high incidence of poverty right across the country with many poor people in distress being compelled by circumstances to borrow from village money lenders at very exorbitant rates of interest ranging from

7% to 10 % per month which is an unbelievable 84% to 120% Per Annum. Many poor Muslims in this vulnerable segment of society, are forced to pawn family jewelry at conventional pawning centres, to raise meager loans to pay for urgent family related expenses. They are forced by circumstances to engage in Riba because there is no institutionalized Islamic system in our society, to assist poor Muslims in dire financial straits. This is the vacuum that Islamic banks must step into.

It is conceded that Islamic banks are not charitable or social welfare initiatives. They are Business entities whose mission is to generate good returns to shareholders and to the investing public. But unlike their conventional counterparts, Islamic Banks must traverse that extra mile to meaningfully assist the poor and the needy, the Fukara and Masakeen whom Allah refers to very frequently in the Quran.

A very modest Qard Hassan portfolio set up from the Banks capital funds, not exceeding two digit millions, is not asking for much by way of a commitment towards this worthy cause. Loans of Rs. 50,000/- to Rs. 100,000/- per person for a period of six months to a year on a fully gold secured basis, is perhaps a good starting point.

Islamic Banks must draw inspiration from what the Apostle of Allah said as narrated by Abu Huraira "If I had Gold equal to the mountain of Uhad, it would not please me that it should remain with me for more than three days, except the amount that I would keep for repaying debts".

7

Debt Obligations – the Ethical Dimension

An important issue that needs to be addressed in this regard is whether debt is permissible in Sharia.

There is nothing mentioned in the Islamic scriptures, discouraging or prohibiting devout Muslims from borrowing money. It is clearly recorded in authentic Hadith that on occasion the prophet of Allah borrowed money in order to tide over immediate cash needs. This however does not mean that Sharia gives blanket approval for Muslims to borrow money at any time and for whatever purpose. There are clearly defined do's and dont's, which an intended debtor is expected to observe.

Types of Debt

(i) Haram (Prohibited) Loans. Loans taken for prohibited transactions and in prohibited ways are totally disallowed in Sharia. Loans taken for business dealings in Tobacco, Alcohol, Non Halal meats, Narcotics, Games of chance such as Lotteries and Gambling, illegal businesses such as smuggling etc. are classed as Haram activities. Loans in this category are outside the spectrum of Sharia and it is a sin for a Muslim to be involved with them in any way.

Equally illegitimate are loans taken for lawful dealings but taken on Riba terms.

(ii) Makru (Discouraged). These are loans taken for acts discouraged in Sharia.

Loans taken to pay for grand wedding expenses or for purchase of expensive motor vehicles, or expensive holidays etc. belong to this category. These are not prohibited in Sharia but avoidance is ranked as an act tantamount to seeking the pleasure of Allah.

(iii) Muba or Jais (Neutral). These are loans taken for purposes which are neutral in Sharia.

Sharia is basically indifferent on the validity of such loans. The bulk of loans taken by people for business purposes or to meet household convenience needs fall into this category.

(iv) Sunna (Recommended). These are loans taken for meritorious deeds. A loan taken to assist a kith or Kin or neighbor who is in financial distress, a loan taken to meet urgent medical needs in the family etc fall into this category.

The Status of the Giver of the Loan (Ceditor)

A person giving loans for purposes allowed in Sharia is performing an act of Sunna. His Niyah (Intension) must be to seek the pleasure of Allah and he must not entertain any expectation of acts or deeds in return from the debtor as compensation for the loan.

Some Sharia Scholars go to the extent of even saying that until the debt is repaid, the creditor must desist from accepting any gifts or favors from the debtor.

The creditor has the optional right to ask for security to protect the loan and the right to demand repayment at the end of the loan period.

In Sharia, the creditor need not seek out the debtor for recovery of the debt, it is the obligation of the debtor to seek out the creditor to repay the loan taken. This is in contrast the Common Law requirement which makes it the creditors obligation to seek out the debtor and demand repayment of the loan.

It is also considered an act of charity for the creditor to give more time for repayment of the loan, if the debtor is in genuine difficulty and requires more time. It is also considered an act of great charity, for the creditor to write off an unsecured loan, when it becomes manifestly clear that the debtor is in great financial distress and is just not able to repay the debt.

It is recommended in the Quran that leniency be shown to debtors, finding it difficult to settle their debts.

> "If however the Debtor is in straitened circumstances (grant him) a delay until a time of ease, it would be for your own good, if you but knew it, to remit(the debt entirely) by way of charity."
>
> - *Quran* 2 280

> "Heed a day when you will be brought back to Allah ,then every soul will be paid in full according to whatever he has earned and they will not be treated unjustly."
>
> - *Quran* 2 281

According to the uncontested evidence of Ibn Abbas the above verse was the last revelation granted to the Prophet ,The Prophet died shortly afterwards. *(Bukhari)*

The Status of the Debtor

As a general rule getting into debt for non essential purposes is strongly discouraged in Sharia. It is strongly recommended that security should be provided to the giver of the loan. Many Prophetic traditions are strong pointers in this direction.

The debtor must have a strong and sincere (Ihlas) Niyah (Intention) to settle the debt as per terms agreed with the creditor. This Niyah must manifest in the debtor by his formulating in advance, a robust, reliable and workable exit strategy to repay the amount borrowed.'Enter the cave only after the exit is identified' is a useful adage to remember. If there is no reliable exit mechanism one must desist from assuming the debt liability. Allah will always help to fulfill a sincere Niyah.

Let us digress for a moment and look at the golden standard that the prophet of Allah exemplified to mankind on this matter. In the Hadith narrated by Hazarat Aisha where the Prophet of Allah pledged his body armor when he purchased grain on credit, we have a very clear exposition of the kind of exit strategy that an intended debtor must formulate prior to engaging in debt. When the prophet of Allah left his house that evening, he realized that he would be returning home with the grain but as a debtor to the Jewish merchant. His intention was probably to repay the debt from the very modest allowance he would draw periodically from the Baithul Maal (Treasury). But that is not the only exit strategy that the prophet of Allah had in mind. His plan A, was probably to repay the debt from his allowance but he also realized that premature death could make plan A totally in operable. He therefore strengthened the exit strategy by additionally opting for a plan B which he clearly demonstrated by taking with him the expensive body armor which he intended to give as security for the debt. We observe from his action the sincere intention that he had to have in place a very reliable exit strategy to repay the debt.

This is the standard that all Muslims and all mankind must emulate.

Debt

The following are some of the important principles documented in authentic Hadiths.

Sharia ranks Debt as a serious contractual obligation and prescribes several guidelines to the debtor, concerning its full and proper discharge.

(i) Its Enormity

Sahih Al Bukhari Vol 3, Book of Al Hawala, Hadith No.495.

Narrated Abu Huraira "Whenever a dead man in debt was brought to Allah's apostle, he would ask 'has he left anything to repay his debt?'. If he was informed that he had left something to repay his debts, he would offer his funeral prayer, otherwise he would tell the Muslims to offer their friends funeral prayer, and he would leave."

This Hadith establishes the following principles;

- A Muslim Must always provide to the creditor, sufficient security for the debt taken. It must be given at the time of disbursement of the loan, for the reason that death which is the most certain thing in life, is also most uncertain as to the moment of occurrence. Security must therefore be given simultaneously with the drawdown of the loan.
- A Muslim who dies with an unsettled debt, for which he did not make arrangements for settlement, has died in sin.
- Such a person may not have the intercession of the apostle of Allah on the day of reckoning.

Bukhari Vol 3, Book of loans, Hadith No. 574.

Narrated Abu Huraira "Allah's Apostle said 'If I had gold equal to the mountain of Uhad, it would not please me that it should remain with me for more than three days, except an amount that I would keep for repaying debts' ."

The principle enshrined in this Hadith is that repayment of a debt must rank in priority over spending money on anything else.

The prophet of Allah said that a person who dies as a Martyr will have all his sins forgiven except the sin of non settlement of debt.(Saheeh Muslim-Kitab al Imara Hadith No. 4646).

(ii) Fear of Debt and its Dangers

Bukhari Vol. 3, Book of loans, Hadith No. 582.

Narrated Aisha "Allah's Apostle used to invoke Allah in prayer saying 'O Allah, I seek refuge from you from all sins and from being in debt' some one said 'O apostle of Allah, I see you very often seek refuge from Allah from being in debt' he replied 'If a person is in debt, he tells lies when he speaks and breaks his promise when he promises".

(iii) Delaying payment of Debt

Bukhari Vol. 3, Book of loans, Hadith No. 585.

Narrated Abu Huraira "Allah's Apostle said 'procrastination in repaying debts by a wealthy person is injustice".

He also said "The delay in payment by one who can afford to pay, justifies his defamation and torture by the lender. Defamation means the lender telling about the delayed payment in public and torture means legal imprisonment".

Quranic Rulings on Debt

There are many verses in the Quran where the creator unequivocally requires devout Muslims to make proper and full settlement of debts.

In Sura Nisa 4 verse 11, the creator lays down clear rules concerning inheritance rights of children. After laying down the formula for distribution, Allah concludes verse 11, by stating very firmly and clearly that such inheritance rights of children rank in priority AFTER the settlement of debts of the deceased testator.

In the same Sura, in verse 12, Allah lays down the formula for distribution of a testators assets to beneficiaries other than children. Here again Allah concludes verse 12 by reconfirming that such inheritance rights are subordinated to rights of creditors and the testators debts must be settled before distribution of assets to legatees.

These are commands imposed on mankind by the creator, they are clear and unequivocal and cannot under any circumstances be transgressed or compromised.

8

Future Prospects

If we try and read the proverbial crystal ball and look into the future to predict where Islamic banking is likely to be in 25 years from today, my guesstimate is that it will be a financial heavy weight in all global financial centres, strongly impacting corporate business and the lives of mankind world-wide. The only down side, that I see retarding its growth will be us Muslims. We have demonstrated apathy, in fact total apathy towards a system of finance which follows the injunctions of the Quran and Sunna.

Statistics bear testimony to this observation. Total bank loans and advances taken by all Muslims in Sri lanka is currently estimated at Rs. 250 Billion, but the business incepted by all Islamic banks today stands at a measly Rs 50 Billion. Despite nearly 20 years of aggressive Islamic banking in Sri Lanka with Islamic Banking services now being available virtually at the door step of every Muslim household in the country, almost Rs. 200 Billion of loans and advances taken by Sri Lankan Muslims are still in the conventional system.

Even globally, Coopers estimate the market capitalization of Islamic trade and businesses at USD 21 Trillion, but Incepted business by all Islamic financial institutions world-wide is only USD 1.5 Trillion. Is this a sign that Muslims of today who proclaim that they are the privileged torch bearers of a magnificent religion, have lost their bearings and with it their Imaan?

I would like to end by sharing with you a very interesting discussion I had with a local senior Banker. We were invited as consultants to assist this big private bank to set up an Islamic Banking unit. Prior to or visit they conducted a survey and asked the large number of their Muslim customers, just two questions. The first question was whether they knew anything of Islamic modes of finance and the other was whether they would prefer to internally migrate to the Islamic division of the Bank if one was set up.

To the first question nearly all who responded, pleaded ignorance.

To the next question the response was as follows;

25%, the seemingly die hard Islamists, unequivocally confirmed their strong support to the initiative.

Another 25% said that if the pricing was about the same, they would consider Migrating.

The balance 50 % said that the Islamic banking initiative was not a mission critical issue to them, and that conventional Banking was a perfectly good comfort zone from which they had no desire to move.

This is the apathy in the Muslim community that I sadly wish to highlight.

About the Author

Mr. A.I. Marikar hails from Negombo and had his education at Maris Stella College, Negombo and Zahira College, Colombo during the Azeez era.

He graduated from the University of Ceylon in 1965 and is an Associate of the Chartered Institute of Bankers in London.

He commenced his banking career at Grindlays Bank, Colombo and left in 1979 to join the Saudi British Bank in Saudi Arabia where he held senior positions. He returned in 1989 and held high posts at Emirates Bank, Middle East Bank and Muslim Commercial Bank.

In 1997 when Amana Investments Limited was inaugurated as the pioneering Islamic financial institution in Sri Lanka, Mr. Marikar joined them as the first Managing Director.

He contributed a great deal to this organization and left their services in 2004.

As an authority on Islamic Banking, he contributed a great deal in formulating the course of studies in Islamic Finance and Banking, when the Faculty of Islamic Studies and Arabic was established at the South Eastern University of Sri Lanka. He is a visiting lecturer.

Mr. Marikar's advice as a Consultant in Islamic Banking was sought after by many banks and finance companies who have introduced such facilities.

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