

The role of Islamic Banks in Economic Development

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ملخص:

لقد أدت الأزمات المالية المتكررة إلى إعادة النظر في نظام التمويل والبحث عن صيغ تمويلية جديدة تلغي الفائدة الربوية التي تعتمد عليها كل الصيغ القديمة المعتمدة في البنوك التجارية. لذا أصبح الاهتمام بالبنوك الإسلامية والصيغ التمويلية التي تعتمد على كآلية بديلة بزيادة في السنوات الأخيرة. سنتناول هذه الورقة البحثية أهم الصيغ التمويلية وأهميتها في النظام التمويلي الدولي من خلال النقاط التالية:

البنوك الإسلامية: المفهوم، النشأة والمبادئ؛
الصيغ التمويلية المعتمدة في البنوك الإسلامية؛
دور البنوك الإسلامية في الاقتصاد.

ABSTRACT :

The recurrence of the financial crisis led to review the financial system and to search for new financial tools that cancel the interest which is adapted in commercial banks.

For that, it becomes necessary to adapt Islamic financial means as alternative mechanisms either through Islamic banks themselves or through opening specialized branches in Islamic financing within commercial banks.

This paper focuses on defining the main financial tools adapted in Islamic banks, the importance of these tools in the international financial systems and more as the following:

- **Islamic banks: definition, origins and principles;**
- **Islamic financing tools;**
- **The role of Islamic banks.**

Introduction:

Over the last fifteen years there has been a rapid expansion of financial institutions that can be characterized as Islamic in that they do not deal in interest based transactions.

This expansion of Islamic financial institutions doesn't concern only Islamic countries but they operate in other locations like: Australia, Bahamas, Canada, Denmark, Jersey, United Kingdom, United States....We mention that in Pakistan, Iran and Sudan, all banks need to operate under Islamic financing principles. Elsewhere, in the mixed systems, the Islamic banks are in a minority and operate alongside conventional banks⁽¹⁾.

In fact, this expansion is a result of the recent financial crisis which influences the strong world economies that depend a lot on interest in their financial transactions, these economies find free-interest financial transactions as alternative of those that depend on interest. These free-interest financial transactions can be found only in Islamic banks.

I- Islamic banks: origins, definition and principles

A- Emergence of Islamic banks:

Islamic bank is an ethical and equitable mode of financial services that derives its principles and its intents from shariaa which is based on the holy Quran and the Sunnah of prophet Mohammed (peace be upon him) and it governs all aspects of personal and collective life.

However, there are many problems associated with research in Islamic banking and financing, most related to the fact that Islamic finance is a new discipline.

These problems can be summarized in these points⁽¹⁾:

- ✓ It has uncertain boundaries and lacks the conceptual and analytical sophistication of conventional economies. Any pretensions aside, the real content of Islamic economics consists of Islamic reflections upon, or an Islamic approach to concepts supplied from conventional economics, concepts like the theory of supply and demand. Islamic economies have not, at any rate not yet, generated general concepts distinct from these of conventional economies,

- ✓ Islamic economies have only recently come to be used as a rational for determining policy objectives and implementation;

- ✓ There is a shortage of scholars sufficiently qualified in both the relevant disciplines, Islamic jurisprudence (fiqh) and conventional finance;

- ✓ There has been a failure to establish modes of reasoning which will allow, for a particular problem, the relevance of arguments from the fiqh or from conventional economics to be determined. Conventional economics is not irrelevant to either the theory or the implementation of Islamic economic policy, and may, in some ways, be of great service;

- ✓ The lack of criteria for determining whether a whole theory of all possible economic relations or transactions is needed, or if Islamic economics could or should confine itself to particular sectors of the economy or to particular sorts of transaction.

It is difficult to say with accuracy which was the first such company or bank, that pioneered this concept in practice. In more recent times, early experiments with Islamic banking took place in Malaya in the mid of 1940s, in Pakistan in the late of

1950s via the Indian Jma at Islami in 1969, Egypt's Mit Saving Banks (1963-67), and the Nasser Social Bank (1971).

Since the mid 1970s, Islamic banking has expanded, so that at present there are nearly 11 countries encompassing most of the Muslim world, which have some form of Islamic financial institutions operating⁽²⁾. Some analysts and experts in the field are of the opinion that the concept of an "Islamic bank" was born at the Islamic Summit of Lahore, Pakistan in 1974 which recommended the creation of an Islamic Development Bank. Since then Islamic banking and financial institutions have grown rapidly⁽³⁾

American Musilm individual and groups have been running many Islamic financial institutions from over a decade now. The launching of the multi-million dollar investment company in London is another indicator of the growing salience of Islamic banking institutions not just in Muslim countries, but in the West as well, but we can't forget that Islamic banks knew their ways to Islamic countries through western banking institution initiates in the fifteenth and the sixteenth centuries when money exchangers established themselves and they grew up credited with good reputation because they helped the industrial revolution- entered into Muslim countries during the colonial rule in the nineteenth century supported by secular laws allowing interest based loans as foreigners required regular payment transfers for their activities (export of raw material, import of manufactured goods) they established branches of their European commercial banks in those countries⁽⁴⁾.

Profit-sharing arrangement such as mudaraba and musharaka almost certainly pre-date the genesis of Islam. Bussines partnerships based on what was in essence the mudaraba concept co-existed in the pre-Islam Middle East along with interest loans as a means of financing activities. Following the birth of Islam interest- based financial transactions were forbidden and all finance had to be conducted on a profit-sharing basis.

Table 1 : shows number of Islamic banking Institution by continent

Continent	No of Banks	%
Africa	32	16.32
Asia	75	38.26
Middle East	75	38.26
Europe	7	3.58
North America	7	3.58
Total	196	100%

Source: Compiled from Islamic banks, Global HR requirements 2009.

B- Definition of Islamic banks

Islamic banking provides services to its customers free from interest, and the giving taking of interest is prohibited in all transactions. Islam bans Muslims from taking or giving interest (riba) , and this prohibition makes an Islamic banking system differ fundamentally from a conventional banking system.

Islamic banking has been defined in a number of ways:

The definition of Islamic bank, as approved by the General Secretariat of the OIC, is stated in the following manner:

♦ An Islamic bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariaa and to the

banning of the receipt and payment of interest on any of its operations. Islamic bankers do not expect to advance money and receive a predetermined sum on a fixed date in the future. Under the shariaa, the drawback of the Islamic faith, they are instead responsible for ensuring that money is invested in viable projects, with reliable borrowers. If the project succeeds the banker shares in the profit, if it fails he suffers the losses⁽⁵⁾;

- ◆ Islamic bank is owned by its shareholders, established to conduct banking and investment activities in accordance with the Islamic shariaa and its own articles of association⁽⁶⁾;

- ◆ An Islamic bank is a financial and banking organization collects, uses money to build up complementary Islamic society, and sets up justice distribution of the role of money in Islam. This organization does its financial work while avoiding dealing with Riba or interest because it's prohibited in Islam, and avoiding any work breaking sharia' principles⁽⁷⁾.

C- Principles of Islamic banking:

The principles of Islamic banking can be found in the shariaa. The original meaning of the Arabic word shariaa was the " way to the source of life and it is now used to refer to legal system in keeping with the code of behaviour called for by the Holy Quora'an with regard to financial products the Islamic code of ethics, the shariaa imposes certain stipulations⁽⁸⁾:

- ☒ The use of instruments based on interest is forbidden. Interest is considered to be unjust, because remuneration for the use of money is agreed in advance. As a consequence , all the risks lie with the borrower and not with the lender;

- ☒ The use of products that are based on uncertainty (gharar) and gambling (maysir) is forbidden. This translates into the rejection of conventional insurance products;

- ☒ Investments in bonds and other interest- based debt securities as well as in e.g: alcoholic beverages, entertainment or pork are not permitted, nor investing in companies that act in contravention of the shariaa;

- ☒ Risk sharing, the provider of the financial capital and the entrepreneur share business risks in return for shares in profits;

- ☒ Money as " potential" capital, money is treated as potential capital that it becomes actual capital only when it joins hands with other resources to undertake a productive activity;

- ☒ The introduction of an Islamic tax, Zakat.

II- Islamic banks Services and financing products:

There are many factors that differentiate one bank from another such as: the law of the country, bank's objectives, banks' circumstances and experiences.....etc. However, they offer some similar services.

Islamic banks perform two types of functions : **fund based and non-fund based.**

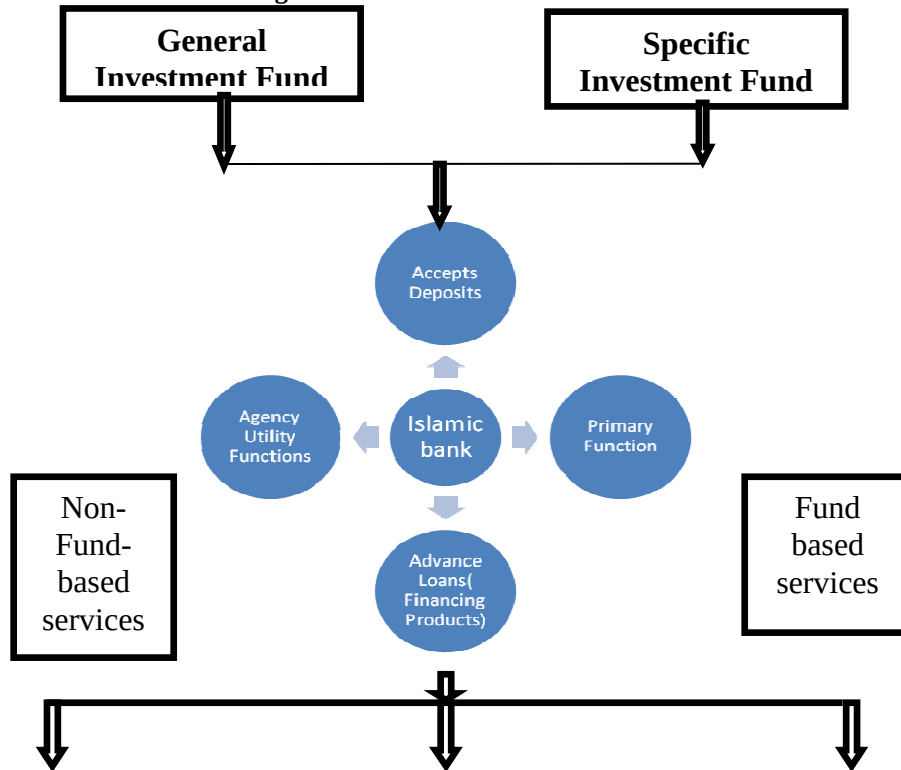
► **Fund based activities:** are called primary functions of Islamic banks i.e. acceptance of deposits from savers on profit and loss basis and lend money to deficient individuals/business units on profit and loss basis. Islamic bank accepts deposits against savings and current accounts. It accepts deposits against investment /savings accounts to generate income under specific investment account or general

investment account. Islamic bank invests this amount into different profitable ventures as an agent and shares the consequences. Bank may receive deposits from people under current account and do not pay any interest but may charge a fee for its services.

Islamic banks lend money to borrowers for short-term ; medium-term and long-term investment on the basis of profit and loss share. In this way depositors, bank and borrowers share risk of loss according to a valid sales contract. It creates a strong economy on the principles of transparency and accountability.

► Islamic bank performs some **non-fund based functions** like agency services and general utility services. Islamic bank can act as an agent to provide the different types of services like : collection of cheques, collection of dividends, purchase/sale of securities. It also performs the general utility services e.g. a collection of utility bills, providing Hajj services...etc.

Figure 1: Functions of Islamic Bank



Long-term	Meddium-term	Short- term
• Musharaka • Mudaraba...	• Ijarah • Ijarah wa Iqtina...	• Murabaha, Salam, Muajjal, Istisna..

Sources: Ashfaq. Ahmed, Asad Afzal Humayoun, Uzair Ul Hassan, **An analysis of functions performed by Islamic bank : A case of Pakistan**, European Journal of Social Sciences. Vol :17, N :1 (2010).

We can also devide the Islamic bank's activities into three categories: Banks services, Banking facilities, Social services and Investment financing

A- Banks services:

Islamic bank provides some services to its clients in order to facilitate and manage the economic transactions. These services are summarized in the following points:

1-Accepting deposits:

There are three sorts of deposits accounts:

✓ **Current account:**

These accounts are presented as demand deposit accounts as in the conventional banks. Diposit is garanteed;

✓ **Common Investment account:**

The depositors or the owners of this kind of accounts aim at participating in the projects that are invested by Islamic banks, in order to obtain returns, whereas the bank has been considered as an agent for depositors, without their intervention. Then at the end of an agreed period, the bank distributes the returns and takes its share as a speculator.

There are three kinds of this account:

a- Saving accounts:

Saving deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk- free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawals demands⁽⁹⁾.

b-Future accounts(Ajil):

Here the depositors cannot withdraw their money only after an agreed period, so in this case, the bank usually invest a big amounts;

: In such accounts, depositors can withdraw their money before a determined period, but they should inform the bank before the withdrawal. The bank

keeps a part of the deposits in form of a liquid money to face the expected withdrawal⁽¹⁰⁾.

✓ **Specific Investment accounts:**

The bank uses the amounts of these accounts in specific projects as : medicines industry, building...etc.

2- Money transfers: This operation indicates the shifting of money or accounts from one account to another, one bank to another from one country to another. What follows that is the transforming of the national currency to foreign currency and vice versa⁽¹¹⁾;

3-Selling and Buying foreign currencies: Islamic banks are not different from other banks except following the terms determined by Islamic scholars to be allowed immediately and fully⁽¹²⁾;

4-Renting sale boxes: This is a contract in which the bank is responsible for safeguarding valuables in rented room used by customer only against rental that varies according to safe size and the period of customer use;

5-Trading in Securities A bank may trade in securities for its client, and ask a fee for it. The legal basis for this in the Shari'a is the agency-contract. The fee, however, should be fixed and reflect the costs and efforts of the bank. Hence, it may not depend on the sum in transaction, unless the size of the transaction influences the bank's effort;

6-Collection of commercial papers and deducted

7-Subscription

B-Banking facilities:

1- Issuance of letters of guarantee

A letter of guarantee given at discharge and delivery by a consignee who is unable to surrender original bills of lading which have been issued. It is commonly provided by a bank and declares that it'll hold the carrier harmless for claims up to a certain sum that may arise from the delivery of goods to a particular person who is unable to surrender the original bills of lading in return for the goods.⁽¹³⁾

2- Confirmation of letter of credit

Under a documentary letter of credit, the issuing or confirming bank principally obligates itself to accept or purchase the beneficiary's draft for the amount indicated in the letter of credit upon the beneficiary tendering the documents called for under the credit, or otherwise complying with the terms and conditions on which the credit was established. Islamic banks treat confirmation of a credit as a kind of guarantee for which a fee should not be charged. However, Islamic bank may charge a fee to a time to cover only the managerial expenses involved in the process of confirmation⁽¹⁴⁾.

A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. If the buyer doesn't make payment, the bank will honor any outstanding payment. It also ensures that seller will not be paid until there is confirmation of goods receipt.⁽¹⁵⁾

C-Social services:

1- Social Activities and the Religious Supervisory Board Islamic banks have to incorporate both profit and morality into their objectives. Consequently, supporting social welfare programmes is a way of fulfilling their religious duty.

Islamic banks finance social activities through the obligatory zakat (wealth) tax and through voluntary donations⁽¹⁶⁾ ;

3- Property management and Zakat;

4- Ujrah: It is a service providing contract whereby an agreement is made between two parties . One party agrees to provide certain services (known as service provider) to other party , and the other party (known as service receiver) agrees to pay for the services provided. The contract must specify the nature of services provided, how long it will be provided and how much royalty to be paid for the services. Islamic banks may make an Ujrah contract to provide some services to another person for payment.⁽¹⁷⁾

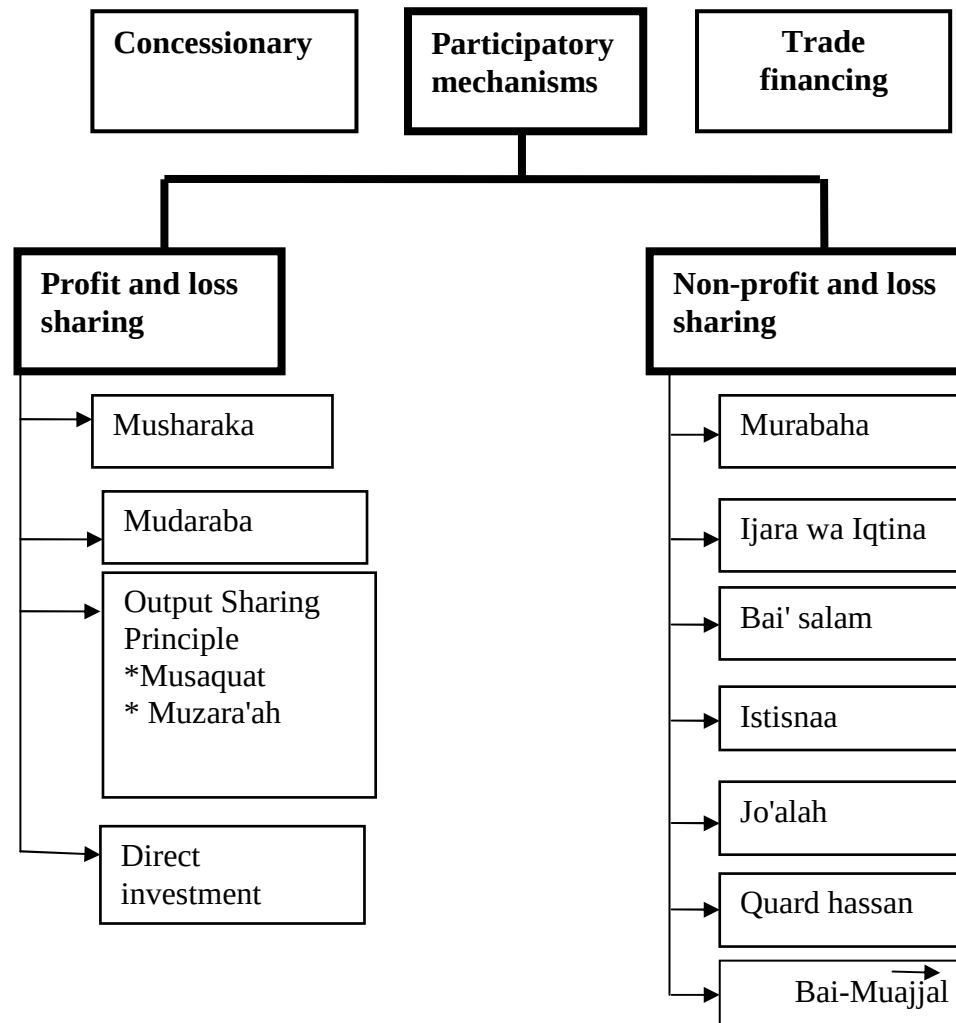
E-Investment financing in Islamic banks:

Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed ⁽¹⁸⁾.

Islamic banks can provide their services in many forms as the following: Musharaka, Mudaraba, Ijarah, Istisnaa, Salam.

There are two kinds of financial contracts in Islamic banks: PLS(Profit and loss-sharing) form which includes: Musharaka, Mudaraba, Musaqat, Muzara'ah and direct investment and Non –PLS financing contracts that include the other types of financing.

Figure 02 : Islamic Banks investment financing



Source: Rahul Dhumale, Anela Sabkanine, Application of Islamic banking system principles to microfinance, Technical note, A study by the regional bureau for Arab States, Unites Nations development programme in cooperation with the middle East and North Africa Region. Worl Bank, P:7.

*** Profit and Loss-sharing contracts (PLS):**

If financing with a fixed return is not allowed. Banks should finance on the basis of a flexible return. One of the possibilities is profit and loss-sharing (PLS), which also comprises equity-based financing. PLS is a form of partnership, where partners share profits and losses on the basis of their capital share and efforts.

Islamic jurists have worked out two forms (contracts) of PLS-financing: joint venture (Musharaka) and trust financing (Mudarabah).⁽¹⁹⁾

1- Musharaka:

Islamic banks use and invest their money in commercial, industrial, agricultural in collaboration. It means that two or more banks share in money among them in the field of agricultural or commercial or industrial or services field, the installment of returns among them according to certain percent of return, without providing that equality shall be in money shares among but risk is only according to percent of capital shares⁽²⁰⁾. There are certain ingredients which are peculiar to the contract of "Musharaka", they are summarized as the following⁽²¹⁾:

- **Distribution of profits:** the proportion of profit to be distributed between the partners must be agreed upon at the time of effecting the contract;
- **Ratio of profit:** There is a difference of opinion among the Muslim jurists about the ratio of profit:

& In the view of Imam Malik and Imam Shafi'i, it's necessary for the validity of Musharaka that each partner gets the profit exactly in the proportion of his investment. Therefore, if A has invested 40% of the total capital, he must get 40% of the profit;

* In the view of Imam Ahmed, the ratio of profit may differ from the ratio of investment if it's agreed between the partners with their free consent;

* The third view is presented by Imam Abu Hanifah. He said that the ratio of profit may differ from the ratio of investment in normal conditions. However, if the partner has put an express condition in the agreement that he will never work for the Musharaka and will remain as sleeping partner throughout the term of Musharaka, then this share of profit cannot be more than a ratio of his investment;

*** Sharing of loss:**

In the case of loss, all the Muslim jurists are unanimous on the point that each partner shall suffer the loss exactly according to the ratio of his investment.

Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.

Types of Musharaka

Musharaka or Profit Loss Sharing may be classified primarily as two broad heads namely : Shirkat-al-Melk or non contractual musharaka and Shirkat-al-Uqud or contractual musharaka⁽²²⁾.

► **Shirkat-al-Melk**

Shirkat-al-Melk is divided into two parts :

- (a) **Shirkat-al-Melk Bil Ekhtiar** or voluntary partnership ; and
- (b) **Shirkat-al-Melk Bil Zabir** or involuntary partnership.

► **Shirkat-al-Uqud**

Shirkat-al-Uqud is also divided into some parts. The following are prominent :

(a) **Shirkat-al-Inan** : Unequal partnership contracts where any party can participate with any proportion.

(b) **Shirkat-al-Mufawadah** : Equal partnership contracts where capital, profit and loss are shared equally.

(c) **Shirkat-al-Wujuh** : Goodwill-based partnership or credit partnership where business is conducted on the basis of goodwill and goods and commodities are hired on credit.

(d) **Shirkat-al-Abdan** : This is a form of general partnership business. This partnership is formed on the basis of labour, skill and management. This is also

called Shirkat-as-Sanai(partnership in crafts or art), Shirkat-al-Amal(on the basis of work) and Shirkat-at-Taqqabbul(partnership in contracting).

(e) Permanent Musharaka or Continued Musharaka where all parties in business contract are engaged continuously in the business.

(f) Digressive or Diminishing Musharaka or Al-Musharaka al-Mutanakissa or Al-Musharaka at-Tanazoleya where one of the two partners or any partner in the contract can withdraw gradually from the project or business by selling part of its share to the other partner. As in the case of a bank, the share of the bank in the profits shall also diminish with the same proportion by which its share in the capital is reduced, while the share of the other partner(here the customer) in both the project and the realised profits will increase at the same time.

(g) Civil Partnership and Legal Partnership : Partnership in Iran has been classified into these two forms : civil and legal. In the former, bank acts one of the co-financiers and in the latter, bank's fund are not treated as in the general pool. It can sell it out its share whenever it likes.

2- Mudarabah:

It is a dual contract between owner of the capital and workers, whether individuals or groups. That means that the capital is paid by a person and the work carried out by another. The first is called the owner of the capital and the second called Mudareb⁽²³⁾. It's a very potent tool for providing interest from the society by providing an interest free tool for skill utilization and it can especially help in mobilizing resources of the society by employing them as a manager, while banks will provide the finance and also bear the chances of profit and loss, which is absent in interest based financing for venture capital.⁽²⁴⁾

Types of Mudaraba :

There are two main types of mudaraba⁽²⁵⁾ : **Restricted and unrestricted mudaraba.**

(a) Restricted Mudaraba : In this type, the capital owner asks the working partner to trade by his capital subject to certain restrictions related to the type of commodity that is to be traded, the time of trade, the place of trading or the person with whom the working partner should trade. The restrictions related to time or persons are approved in both the Hanbali and Hanafi Schools but not approved in Shafi and Maliki Schools.

(b) Unrestricted Mudaraba : In this case, the working partner or mudarib can trade in any commodity (that is legitimate), with any persons which he deems appropriate without being restricted to certain period of time or place.

Other Forms of Mudaraba Contract :

* **Mudaraba Mutlaq** : Non-contractual mudaraba and **Mudaraba Muqaiadah** : contractual mudaraba

* **Single Mudaraba** : Where one Mudarib and one provider of funds take part in the contract and **Compound Mudaraba** : Where a number of Mudarib and a number of providers of funds, or a multiplicity of mudarib and one provider of funds, or a multiplicity of providers of funds and one mudarib take part in the contract.

* **Limited Term Mudaraba** : In this type of mudaraba, profits are accounted for at the time the work is liquidated, and in case of **Continuous Mudaraba**, profits are accounted for on a periodical basis during the mudaraba period.

* **Commingledd Mudaraba** : Mudaraba funds are invested by both parties to the contract while the work is carried out by the mudarib alone, and in **Non-commingledd Mudaraba**, mudaraba funds are invested by the provider of funds only.

3- Output Sharing Principle :

In this type of contracts, output or produce is shared between the parties in contract. Output sharing contracts are mainly of two types namely, Muzara'a and Musaqat.

a- Muzara'a : It is a contract between an owner of a piece of agricultural land and a farmer for farming it in return of a percentage of its crop. In case of bank, bank provides farmers land (to which is possessed by the bank itself) for cultivation on crop sharing.

b- Musaqat (Irrigation): is a partnership that depends on one party presenting designated plants/trees that produce usable products /items/goods/output to another in order to work on their irrigation in consideration for a common defined share in fruits.

This mode is applicable in agriculture sector in a very effective manner, especially for orchard financing. A specific or predetermined share of the enterprise output will go to the provider for labor and enterprise. This will be clearly positioned in the contract⁽²⁶⁾.

4-DIRECT INVESTMENT

Direct investment is an important and productive financing technique for Islamic banks. With direct investment, an Islamic bank functions more like an investment company than an institution of financial intermediation. In comparison to conventional banks, this gives Islamic banks more leverage to vigorously perform a socially useful role. The option of direct investment gives Islamic banks an opportunity to invest in priority projects in chosen sectors. In this way, banks can channel their funds in the direction they think most desirable⁽²⁷⁾.

There are several ways in which Islamic banks undertake direct investment. A number of Islamic banks have taken the initiative in establishing and managing subsidiary companies. Conceptually, these companies could be of any type and concerned with any trade. However, the general trend is towards the establishment of companies dealing with investment, insurance and reinsurance, trade, construction and real estate, etc.

Another method of undertaking direct investment is participation in the equity capital of other companies. In this connection, two distinct patterns are noticeable:

- i. the companies are established by the Islamic banks themselves and the public subscription of shares is invited. In this case, Islamic banks share in the equity capital with other individuals and companies;
- ii, banks participate in the equity capital of companies established by others.

In both cases, Islamic banks attempt to make sure that the projects are of public benefit and comply with the Islamic *Shari'ah*.

* Non –PLS financing contracts

1-Murabaha:

Islamic banks have adopted Murabaha to provide mainly short term finance to client to purchase goods even though the client may not have the cash to pay. In other words, it is selling something of original price in addition to increased

information for buyer which is represented as marginal return for seller, which is one of selling types of royalty that is one of selling contracts. The selling of product must be intent for money⁽²⁸⁾.

The basic features of a Murabaha contract are the following⁽²⁹⁾:

* The buyer should have knowledge of all related costs and original price of the commodity, and the profit margin should be defined as a percentage of the total price plus costs;

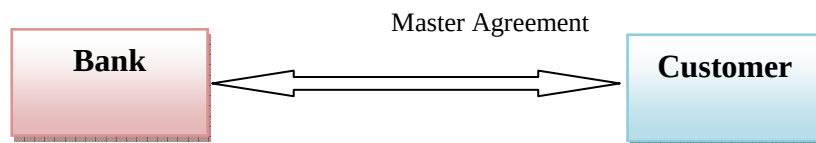
* The subject of the sale should be goods or commodities against money;

* The subject of the sale should be in the possession of the seller and owned by him and he should be capable of delivering to the buyer.

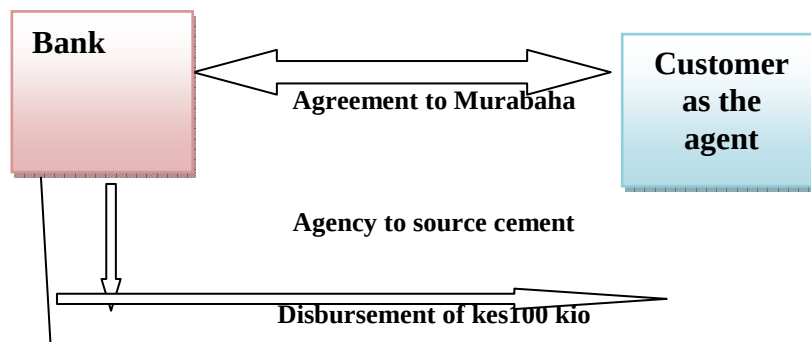
Steps of Murabaha mode investment:

To simplify the main steps that Murabaha mode investment follows we present an example of cement company⁽³⁰⁾:

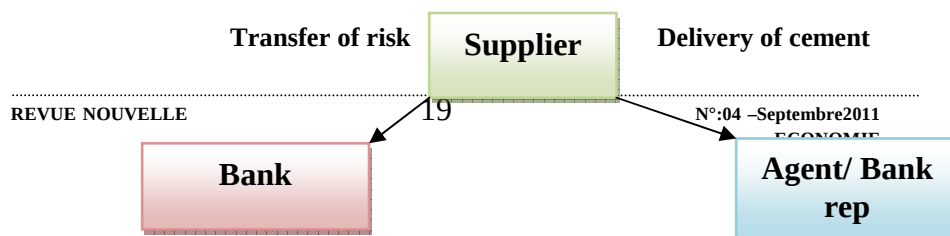
1. Client and bank sign an agreement to enter into Murabaha Master Financing Agreement along with Agency Agreement. (MMFA).



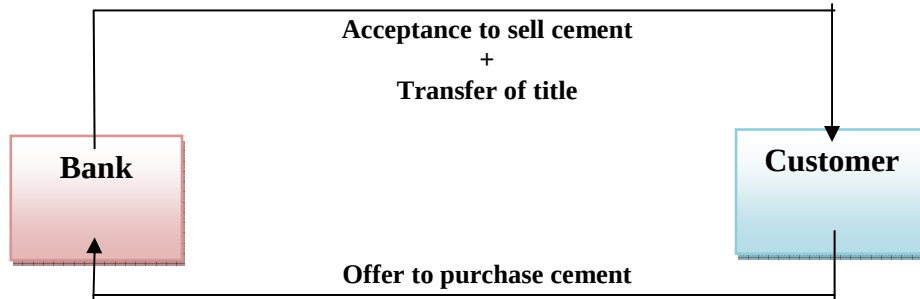
2. Client is appointed as an agent to identify and source cement on behalf of the bank



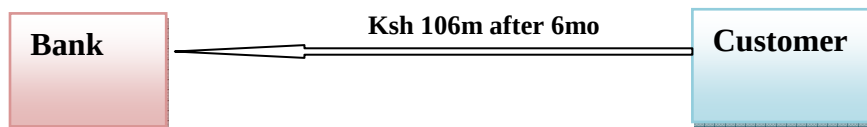
4. The bank or its agent takes possession of cement.



5. Client makes an offer to purchase the cement from bank.
6. Bank accepts the offer and sale of cement is concluded.



7. Client pays agreed price to bank according to an agreed schedule.



The Customer then makes an offer to purchase it at KES 106 million to be paid after six months by signing the Offer.

The bank accepts the offer and the sale is concluded whereby ownership as well as risk is transferred to the Customer. The Customer pays KES106m after 6 months

2-Ijarah:

Ijarah or lease-based transactions are becoming increasingly popular and have a significant portion of the current Islamic banking and finance market. It is a form of leasing in which the bank acquires the asset, whether real estate or otherwise, and then immediately leases that asset to the customer for a determined period of time. It's divided into **regular Ijarah** and **Ijarah muntahia bittamlik**, in **Regular Ijarah**; the specified asset shall be returned to the lessor after the specified period. In the second one, at the end of a determined period the customer will own the asset, either by the terms of the lease or by purchasing it at an agreed-upon nominal sales price⁽³¹⁾, that what's called **Ijarah muntahia bittamlik** or **ijarah summa al-bai and kiraa waqtina**.

Ijarah muntahia bittamlik is a hire-purchase contract, in this type of transaction the hirer hires goods or real property for periodical rents and at the end

of rental period he has an option to buy the goods. In **Ijarah muntahia bettamlik**, the ownership in the goods initially does not pass to the hirer, the ownership only passes when the goods are sold to the hirer at the end of the hired period or any time during the hired period. When the goods are sold to the hirer, the sale should be evidenced in a separate in a separate sale contract.

It is possible that some Islamic banks may invite other investors to participate in the leasing operation. For example, some investors and an Islamic bank may participate in an income yielding real asset leasing project. All participants in this venture take their share of profit out of the rental in-come. The bank also has the right to repurchase a participation according to the agreed terms⁽³²⁾.

The selling price will be determined by agreement between the parties. However, the owner of the goods may give the goods to the hirer as a gift(hiba) under aqdal-hiba.⁽³³⁾

There are some basic rules of Ijarah or “leasing” as the following⁽³⁴⁾:

- ✓ It is contract whereby the owner of something transfers its usufruct to other person for an agreed period, at an agreed consideration;
- ✓ The subject of lease must have a valuable use. Therefore, things having no usufruct at all cannot be leased;
- ✓ It is necessary for a valid contract of lease that the corpus of the leased property remain in the ownership of the seller, and only its usufruct is transferred to the lessee. Thus, anything which cannot be used without consuming cannot be lease out;
- ✓ The period of lease must be determined in clear terms;
- ✓ The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement. If no such purpose is specified in the agreement, the lessee can use it for whatever purpose it is used in the normal course;
- ✓ The lessee is liable to compensate the lessor for every harm to the leased asset caused by any misuse or negligence on the part of the lessee;
- ✓ The leased asset shall be remained in the risk of the lessor through the lease period in the sense that any harm or loss caused by the factors beyond the contract of the lessee shall be born by the lessor;
- ✓ It is necessary for a valid lease that the leased asset is fully identified by the parties;
- ✓ The determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules of the Shari’ah, if both parties agree to it, provided that all other conditions of a valid lease prescribed by the Shari’ah are fully adhered to.
- ✓ The lessor cannot increase the rent unilaterally, and any agreement to this effect is avoid.
- ✓ The rent or any other part thereof may be payable in advance before the delivery of the asset to the lessee, but the amount so collected by the lessor shall remain with him as ‘on account’ payment and shall be adjusted towards the rent after its being due.
- ✓ The lease period shall commence from the date on which the leased asset has been delivered to the lessee, no matter whether the lessee has started using it or not.

✓ If the leased asset has totally lost the function for which it was leased, and no repair is possible, the lease shall terminate on the day in which such loss has been caused. However, if the loss is caused by the misuse or by the negligence of the lessee, he will be liable to compensate the lessor for the depreciated value of the asset as, it was immediately before the loss.

3-Salam:

It is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. Here the price is cash, but the supply of the purchased goods is deferred. The buyer is called "Rabb-us-salam", the seller is "Muslam-illaih", the cash price is "Ra's-ul-mal" and the purchased commodity is termed as "Musalam fih".

There are some conditions that should be in salam transaction⁽³⁵⁾:

✚ It is necessary for the validity of salam that the buyer pays the price in full to the seller at the time of effecting the sale;

✚ Salam can be effected in those commodities only the quantity and quality of which can be specified exactly;

✚ It cannot be effected on a particular commodity or on a product of a particular field or farm;

✚ The quantity and quality of the commodity should be agreed upon in unequivocal terms;

✚ The exact date and place of delivery must be specified in the contract;

✚ Salam cannot be effected in respect of things which must be delivered at spot.

For example, if gold is purchased in exchange of silver, it is necessary, according to shariaa, that the delivery of both should be simultaneous.

4-Istisna:

It is a kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him with material from the manufacturer, the transaction of Istisna comes into existence. But it's necessary for the validity of Istisna that the price is fixed with the consent of the parties and that necessary specification of the commodity is fully settled between them⁽³⁶⁾.

5- Jo'alah: is a contract on the basis of which one party (the jaa'el bank of employer) undertakes to pay a specified amount of money (jo'al) to another party (the amel or contractor) for rendering a specified service in accordance with the terms and conditions of the contract. The concept of jo'alah is similar to that Istisna'a. Whereas in Istisna'a the seller provides a physical commodity, in Joa'lah the seller provides a service rather than a physical commodity.

Jo'alah is essentially a contract for the beneficial use of a skill or professional service. In this contract, two elements have to be precisely defined: (a) the amount of reward offered and (b) the nature of service to be accomplished⁽³⁷⁾.

6- Bai-Muajjal or Cost plus sale under deferred payment:

The Bai-Muajjal mode of investment is as like as a Murabaha mode of investment with an exception that the sale under this cost-plus sale modes investment

is made on a credit basis rather than cash. The main feature of this technique consists in procurement of goods at the request of the client and selling it to him /her on credit. This mode follows the same conditions as Mudaraba mode of investment except the following⁽³⁸⁾:

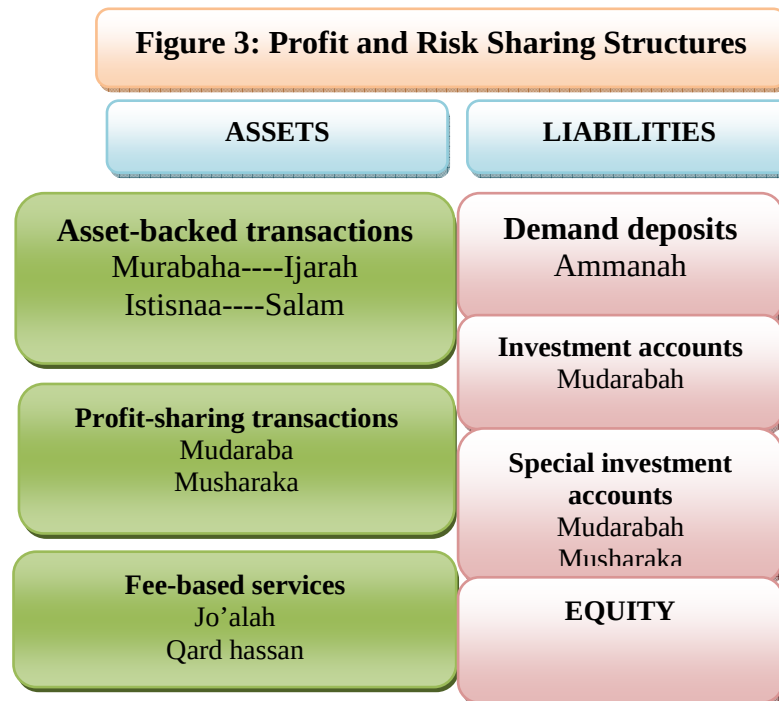
✚ The bank transfers the possession of goods to the client before payment;

✚ In order to cover the sale price of the goods the bank obtains collateral securities from the client;

✚ The bank normally takes property of Municipal area as mortgage. In case the client fails to repay the sale price, the bank realizes the amount by selling the mortgage property.

7-Qard hassan: (good loan/benevolent loan) This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. Some Muslims consider this to be the only type of loan that does not violate the prohibition on riba, since it is the one type of loan that truly does not compensate the creditor for the time value of money⁽³⁹⁾

The figure below shows the main Islamic banks financing tools divided into assets and liabilities



Source: Dalila Abu Bakar reports, **Basel II Enhances Islamic Banks**.
August/September 2008 . Islamic Finance Asia.

Also there are other activities that Islamic banks do in the context of their social and economic roles like⁽⁴⁰⁾:

☒ **Wakalah**

Wakalah is an agency contract between the principal and the agent. The principal is known as *muakkil* and the agent is known as *wakil*. In *wakala* contract, the *wakil* agrees to perform a certain act on behalf of the *muwakkil* for payment as agreed by the parties. Both the parties in agency contract must have capacity to make a contract. If both of them are of sound mind and have attained the age of 15,3 are capable of making a valid agency contract. Under a *wakala* contract the *wakil* is required to abide by all the instructions given by the *muwakkil* while performing his duty, unless the *wakil* will be responsible for any resulting loss to the *muakkil*.

Islamic bank can act as a *wakil* under a *wakala* contract to do an act for the *muakkil* or the Islamic bank can appoint a *wakil* to have its work done by him. *Wakala* contract is valid in Islam as *riba* or *gharar* is not present in this type of contract.

☒ **Ar-Rahnu**

Ar-rahnu is known as charge or pledge or mortgage. In *ar-rahnu*, borrower of money puts his valuable property such as land, building, gold jewellery etc. as charge to secure the loan he takes from an Islamic bank. Islamic banks cannot provide conclude *murabahah* or *bai istisna* contract or *qard al-hasan* without securing the loan with a valuable property of the borrower because now-a-days people are not trustful. They are negligent to pay back the loan given as *qard al-hasan*. *Ar-rahnu* on valuable property of a borrower provides security and peace of mind of Islamic bank managers in case the borrower fails to pay the loan on time. There are two parties in *ar-rahnu* contract. The chargor and the chargee. The person who charges his

valuable property as security for loan is called chargor (borrower of money) and the person who takes the valuable property as charge (*rahnu*) to secure the loan given is called chargee (Islamic bank) If the chargor fails to pay the benevolent loan or credit, the chargee has right in law to take possession and sell the charged property to a third party for market price. From the value of the property sold, the charge can take full amount of benevolent loan or credit due and if there is any extra money left, he must pay to the chargor.

☒ **Kafala**

Kafala means guarantee. It is an alternative to *ar-rahnu*. Islamic bank can provide *qard al-hasan* or credit facility to someone if another person becomes a guarantor for the loan or the credit. The guarantor provides guarantee that in case the borrower of money or the debtor fails to pay the sum due, the guarantor will pay the amount due to the lender or the creditor. So, *kafala* works as security for loan or credit given to a person or a business enterprise. Now-a-days people are not sincere enough to pay back the loan or credit amount to the lender or the creditor. Therefore, the lender or the creditor wants guarantor for the loan or credit facility offered.

III-Roles of Islamic banks

Islamic banks play a major role in economic system, through collecting resources and distributing them in a fair manner. The following points indicate the main roles of Islamic banks⁽⁴¹⁾:

- ✓ Islamic bank , as a financial institute, is an association of capital owners, as shareholders, and investors, as depositors, who are initiating the path to cure the financing ills in the areas of investment, banking, insurance and economic development through non-interest bearing loans, capital provision and partnership ventures;

- ✓ Economic life has grown more complex, so too the range of uncertainties confronting business enterprises has extended with it the demand from individuals and firms for more sophisticated ways of handling such uncertainties. The Islamic banking framework is therefore a form of economic insurance for Islamic community since it has undertaken to enable business and investment transactions to be executed in an Islamic manner by attracting funds of all forms from investors and distributing the accumulated capital pool into diverse productive economic sectors;

- ✓ The collective approach through a banking system, is economically profitable and an avenue through which financial risk is distributed between a large group of investors;

- ✓ Islamic banking also forms an effective unit in the Islamic Economic System. These banks could be used as a step towards the creation of Islamic Insurance companies;

- ✓ Islamic banking doesn't only aim to provide returns for investors and finance for those in need of capital, but it also protects economic interests of Muslims and promotes the sharia'a interpretation of finance.

- ✓ Through an exhaustive test of Shariah compliance. They are not allowed to invest in narcotics, casinos, nightclubs, breweries etc. This requires that the clients of Islamic banking must have business which should be socially beneficial for the society, creating real wealth and adding value to the economy rather than making paper transactions.

- ✓ The focus of Islamic bank on profitability and rate of return of investments due to equity and profit sharing has the potential of directing financial resources to the most productive investments and hence increase the efficiency of the financing process and in the real sector⁽⁴²⁾;

- ✓ The role of Islamic banks is not limited to a passive financier concerned only with timely interest payments and loan recovery. Islamic bank is a partner in trade and has to concern itself with the nature of business and profitability position of its clients. To avoid the loss and reputational risk, the Islamic banks have to be extra vigilant about their clientele. As such, Islamic banks are less likely to engage in illegal activities such as money laundering and financing of terrorism than conventional banks;

Islam encourages the earning of profit as profit symbolizes successful business dealing and creation of new wealth. Interest on the other hand is a cost that is in place regardless of the outcome of business operations. If business losses are experienced, there may not be real wealth creation. Social justice requires that lenders and borrowers share both profit and loss in an equitable manner and that the method of accumulating and distributing wealth in the economy is fair and

represents true productivity, we can state the role of each mode of financing in Islamic bank as below⁽⁴³⁾

✓ Musharakah encourages partnerships, also created jobs for many people in society, promotes enterprise and partnership ventures, creating jobs in the country, promotes business enterprise culture in society and growth of skilled people. Musharakah has a potent effect on controlling inflation and spread of baseless credit, promoting joint ventures without potent investigations and research ensures business successes, not speculations;

✓ Mudarabah is a very potent tool for removing interest from the society by providing an interest free tool for skill utilization and it can especially help in mobilizing resources of the society by employing them as a manager, while banks will provide the finance and also bear the chances of profit and loss, which is absent in interest based financing for venture capital. Mudarabah has a significant effect on reducing the unemployment in both the short and long run, as it encourages business management by skilled people and promotes commercial activity. Mudarabah also helps control inflation by promoting interest free business activities. Interest and credit creation of banks through lending are the major source of inflation in society. Mudarabah involves bank or other capitalists bearing in both profit and loss, and not just making earnings through a predetermined interest rate exploiting the needs of individuals or firms;

✓ Ijarah has no direct effect upon poverty reduction and has a little effect on reducing unemployment. However, it has great potential for protecting against inflationary harms to middle class people and entrepreneurs, by allowing the use of assets without sudden cash outflows. It enables them to modify or replace, even after some months or years, their equipment or machinery without much cash flow swings. But Ijarah, like ordinary lease, can sometimes leads to inflation itself if the economy is working at the full employment level, then boosting demand of goods which will further increase prices in the market;

✓ Istisna is especially useful in the housing sector, boosting the construction demand, creating employment and wealth to society without harmful effects of interest. It has also good effects on the reduction of unemployment by boosting construction and house building activities in society. Istisna has a little effect on inflation control;

✓ Salam is very useful in reducing agricultural sector poverty easily, by enabling the banks and farmers to contract with each other of the crops and to get finance at an appropriate time, instead of usurious loans, which ultimately deteriorates through the compounding of interest. Salam also has great potential in reducing rural sector unemployment and reduces trend towards urbanization, by enabling farmers and agriculturists to work. Salam engages them at villages and towns, thus decreasing the unemployment burden. This generates agricultural and rural sector development and eventually more income for these poor people. Salam has a great effect on reducing inflation, where food stuff has reached its peak prices, the main way it cuts inflation is through ensuring increased aggregate supply and reduce food product deterioration by use of pesticide and fertilizers at appropriate times, boosting the yield of land and farms to much extent.

Conclusion:

Islamic banks expand rapidly worldwide due to the important roles they play in social and economic levels either in Islamic or non-Islamic countries. They are considered as an alternative of the conventional transactions in interest-based economies which have expected great failures.

The many types of financial contracts that are provided by Islamic banks contribute not only in economic prosperity of countries but also in social fairness through the redistribution of revenues.

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