# ISLAMIC BANKING

## (AD/BS Accounting & Finance)

Units: 1-9 Code: 5421



Department of Commerce
Faculty of Social Sciencs & Humanities
ALLAMA IQBAL OPEN UNIVERSITY

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**Faculty of Social Sciences & Humanities**
**Allama Iqbal Open University**
**Islamabad**

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# FOREWORD

Islamic banking has emerged as a beacon of ethical finance, offering a sustainable and equitable alternative to conventional banking systems. Rooted in Shariah principles, Islamic banking emphasizes fairness, risk-sharing, and the prohibition of interest (riba), creating a financial ecosystem that aligns with the moral and social values of Islam. This growing sector has proven to be a viable solution for addressing economic disparities and fostering inclusive growth. The increasing demand for Islamic financial services underscores the need for comprehensive educational resources to prepare future professionals and leaders in this field.

This book, "Islamic Banking," Code 5421 is a meticulously crafted resource that bridges theoretical foundations with practical applications. Divided into nine thoughtfully organized units, it delves into critical areas such as the principles of Islamic economics, the sources and uses of funds in Islamic banking, and the unique modes of financing employed by Islamic financial institutions. Each unit is designed to build a holistic understanding of Islamic banking, empowering students and professionals to apply these concepts effectively in their careers.

The book's focus on contemporary issues, such as risk management, financial accounting, and regulatory frameworks, ensures that readers gain not only foundational knowledge but also insights into the current challenges and opportunities in Islamic banking. Moreover, the dedicated unit on the status of Islamic banking in Pakistan provides a contextual understanding of its growth and significance in our local financial landscape. This makes the book particularly relevant for those aspiring to contribute to the development of Islamic banking in Pakistan and beyond.

As the Dean of the Faculty of Social Sciences and Humanities at Allama Iqbal Open University, I take immense pride in presenting this resource. It reflects our commitment to academic excellence and our mission to provide high-quality, accessible education in fields that have a profound impact on society. I am confident that this book will serve as a valuable tool for students, researchers, and practitioners, inspiring them to explore and advance the principles of Islamic banking. Let this book be a guiding light for those who wish to align their professional endeavors with ethical and socially responsible practices.

**Abdul Aziz Sahir**
**Dean Faculty of Social Sciences and Humanities**
**Allama Iqbal Open University**

# PREFACE

The financial industry has undergone a paradigm shift in recent years, with Islamic banking emerging as a dynamic and rapidly expanding sector. Unlike conventional banking systems, Islamic banking is built on the principles of justice, equity, and the prohibition of interest (riba), providing a sustainable and ethical framework for economic activities. This transformative approach to finance resonates deeply with the values of fairness and shared prosperity, making it an appealing alternative in both Muslim-majority and non-Muslim countries alike. Recognizing the critical role of education in shaping the future of this sector, Allama Iqbal Open University is proud to present this book, "Islamic Banking."

The book's content has been thoughtfully designed to provide a comprehensive understanding of Islamic banking principles and practices. Beginning with the Islamic economic system, it lays a strong theoretical foundation before delving into the operational aspects of Islamic banking, such as sources and uses of funds, modes of financing, and risk management strategies. By addressing these core areas, the book equips readers with the knowledge and skills necessary to navigate the complexities of Islamic financial systems.

In addition to its practical applications, this book explores the regulatory and Shariah governance frameworks that are essential for ensuring compliance with Islamic principles. The detailed discussion on the status of Islamic banking in Pakistan offers valuable insights into the growth and challenges of this sector in our local context. Furthermore, the unit on financial accounting and reporting highlights the unique requirements and standards that distinguish Islamic banks from their conventional counterparts. These features make this book a valuable resource for students, academics, and professionals seeking to deepen their understanding of Islamic banking.

As the Vice Chancellor of Allama Iqbal Open University, I am pleased to see this book contribute to our institution's mission of promoting quality education and research. It reflects our dedication to addressing contemporary challenges and providing solutions that are both practical and aligned with ethical values. I extend my heartfelt gratitude to the authors, editors, and contributors whose efforts have brought this book to fruition. I am confident that it will not only enrich the academic journey of our students but also inspire them to play a pivotal role in advancing the principles of Islamic banking in their professional careers.

May this book serve as a stepping stone for the development of a financial system that prioritizes fairness, inclusivity, and social responsibility.

**Prof. Dr. Nasir Mehmood**
**Vice Chancellor**

# COURSE INTRODUCTION

The course "Islamic Banking" is thoroughly designed to provide an in-depth understanding of the principles, practices, and unique frameworks that constitute Islamic banking. Through nine comprehensive units, this course offers a detailed exploration of the Islamic economic system, banking principles, sources and uses of funds, risk management, financial markets, regulatory frameworks, the status of Islamic banking in Pakistan, and financial accounting within Islamic banks. Each unit is crafted to ensure that students not only grasp the theoretical underpinnings of Islamic banking but also appreciate its practical applications in the contemporary financial landscape.

**Unit-1** introduces students to the foundational concepts of the Islamic economic system. It emphasises the role of humans as servants of Allah, tasked with conducting economic activities according to divine principles to promote justice and equality in society. This unit covers the historical evolution of Islamic banking during the time of Prophet Muhammad (ﷺ) Khaataman Nabiyyeen حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ and explores the primary sources of Shariah principles: The Quran and Sunnah. Students will also examine the flow of wealth within an economy to prevent wealth concentration and the comparison of the Islamic economic system with capitalist economies. Additionally, the development of modern Islamic banking will be discussed.

**Unit-2** delves into the core principles and concepts underlying Islamic finance and banking. Students will learn key terms such as Shari'ah, Aqidah, Fiqh, Ibadat, and Muamalat, and their relevance in Islamic economics. The unit also covers the sources of Shariah law, including Ijma and Qiyas, and the prohibition of Ribah (usury) as outlined in the Quran and Hadith. Furthermore, the principles and framework of Islamic banking are analyzed, highlighting significant differences from conventional banking systems.

**Unit-3** focuses on the sources of funds in Islamic banking, crucial for understanding the operational mechanisms unique to this financial system. It begins with an examination of various sources of funds, including deposits and shareholders' funds. The unit then explores major modes of profit and loss sharing, such as Mudarabah and Musharakah, providing insights into their implications for deposit management and practical applications in Islamic Finance.

**Unit-4** helps the students in exploring the various financing modes used by Islamic banks, rooted in Shariah law. This includes trade/sale-based modes, lease-based modes, and profit and loss sharing modes. The unit aims to provide a comprehensive

understanding of how these financing modes operate within the ethical and religious principles guiding Islamic banking transactions.

Risk management is essential for the stability and sustainability of financial institutions, and **Unit-5** addresses its unique dimensions in Islamic banking. The unit covers the nature of risk, fundamental principles of risk management, and the types of risks Islamic banks face. Emphasis is placed on Shariah compliance and the strategies and tools used to mitigate risks while maintaining ethical integrity. The role of regulatory frameworks and governance structures in promoting sound risk management practices is also highlighted.

**Unit-6** provides an in-depth exploration of the Islamic Financial Market, examining the mechanisms governing financial transactions within Islamic finance principles. It starts with an overview of various financial market categories, followed by detailed discussions on the Islamic Money Market and Islamic Capital Market. This unit aims to equip students with a comprehensive understanding of the structure and function of Islamic financial markets.

**Unit-7** examines the regulatory framework governing Islamic banking, including its historical context, regulatory bodies, Shariah governance, and challenges faced. It provides students with a thorough understanding of the principles and guidelines unique to Islamic banking, ensuring compliance and integrity within the industry. This knowledge is essential for comprehending the regulatory landscape that governs Islamic banking institutions worldwide.

**Unit-8** focuses on the development and evolution of Islamic banking in Pakistan. It provides a comprehensive overview of the current landscape, and performance, and a comparative analysis of Islamic banking systems worldwide. This unit highlights the significant progress and current status of Islamic banking in Pakistan, offering valuable insights into its growth and development.

The final unit, **Unit-9** addresses the critical aspect of financial reporting in Islamic banking. It covers the fundamentals of financial reporting, its application in Islamic financial institutions, and the importance of adopting specialized standards such as those developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This unit ensures students understand the requirements for accurate and Shariah-compliant financial reporting.

Through these nine units, the course "Islamic Banking" provides a comprehensive understanding of the principles and practices of Islamic banking, preparing students to effectively navigate and contribute to this dynamic and growing field.

# COURSE OUTLINE

The "Islamic Banking" course aims to provide students with a comprehensive understanding of the fundamental principles, practices, and regulatory frameworks of Islamic banking and finance. Upon completion of this course, students will be able to:

1. Foundations of Islamic Economics:
   - Understand the historical evolution and principles of the Islamic economic system.
   - Recognize the role of divine guidance and Prophet Muhammad (ﷺ) Khaataman Nabiyyeen in shaping economic behaviour.
   - Differentiate between Islamic and capitalist economic systems.

2. Core Principles of Islamic Banking:
   - Grasp key concepts such as Shariah, Fiqh, and Aqidah.
   - Analyze sources of Shariah law and their application.
   - Understand the prohibition of Riba and its implications.

3. Sources and Uses of Funds in Islamic Banks:
   - Identify various sources of funds, including deposits and shareholders' funds.
   - Explore major products and modes of financing, such as Mudarabah and Musharakah.
   - Understand the operational dynamics and significance of key financial instruments.

4. Risk Management in Islamic Banking:
   - Examine principles of risk management with emphasis on Shariah compliance.
   - Identify and evaluate different types of risks.
   - Discuss strategies and tools for mitigating and managing risks.

5. Islamic Financial Markets:
   - Understand the structure and functions of Islamic financial markets.
   - Explore the Islamic Money Market and Islamic Capital Market.
   - Compare Islamic financial markets with conventional ones.

6. Regulatory and Shari’ah Governance Frameworks:
   - Comprehend the necessity and objectives of the regulatory framework.
   - Trace the historical context and evolution of Islamic banking regulation.
   - Familiarize with the roles of regulatory bodies and authorities.

7. Present Status of Islamic Banking:
    - Understand the development and current landscape of Islamic banking in Pakistan.
    - Analyze the performance of Islamic banking institutions locally and globally.
    - Compare Islamic banks with conventional banks using key financial indicators.

8. Financial Accounting and Reporting:
    - Understand the significance of financial reporting for Islamic banks.
    - Explore tailored financial reporting standards for Islamic financial institutions.
    - Familiarize with AAOIFI standards for Shariah-compliant financial reporting.

These objectives equip students with a thorough understanding of Islamic banking, preparing them for effective contributions to the field.

**Unit–1**

# ISLAMIC ECONOMIC SYSTEM

**Written by: Dr. Nosheen**

**Reviewed by: Dr. Muhammad Suleman Afzal**

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# INTRODUCTION

Man is the servant of Allah on earth. He is required to fulfil his obligations according to the guidelines provided to him by ALLAH. Human beings for their sustenance are required to perform economic activities. These economic activities should be performed according to divine principles to ensure equality and justice in society. Islam has laid down an Islamic economic system which is a complete framework based on Shariah rulings to guide the people about every aspect of earnings sustenance. In the first unit of this study guide, students will be taught the evolution of Islamic banking during the time of Prophet Muhammad (ﷺ) Khaataman Nabiyyeen

حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ

Students will also learn about two sources of Shariah Principles: Quran and Sunnah. To understand how to avoid the concentration of wealth in a few hands, the flow of wealth in the economy will also be discussed. To analyse the key differences between the Islamic economic system and capitalist economies, we need to evaluate each of them from different perspectives. Lastly, how today's modern Islamic banking evolved over the period will also be discussed.

# OBJECTIVES

The main objectives of this unit are to give the students an insight into the history and evolution of modern Islamic banking, the basics of the Islamic economic system and the capitalistic economic system.

At the end of this unit, you will be able to,

1. Understand the significance of divine guidance in shaping economic behaviour.

2. Analyze and appreciate Prophet Muhammad (ﷺ) Khaataman Nabiyyeen
   حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ
   role as a trader and its relevance to Islamic economic principles.

3. Differentiate between the capitalist and Islamic economic systems.

4. Identify the objectives of wealth distribution in Islam.

5. Trace the evolution of the modern Islamic banking system, from its historical origins to contemporary practices.

## 1.1 Belief in Divine Guidance

Everything in this universe belongs to ALLAH as mentioned in the Holy Quran.

> *"To God belong all things in heaven and earth: verily God is He (that is) free of all wants, worthy of all praise" Surah Luqman (31:26).*

We as His servants and His slaves belong to Him as well, we do not own anything in this world. He has created man and appointed him as His slave to act in His path by obeying his commands and to please Him. His commands are not only restricted to the religious act of worship but cover almost every aspect of our lives. He has entrusted us with the physical assets as well as the human intellect which we are required to use in the way prescribed by Him. We are required to use these assets and resources for the benefit of the community and are required to use intellect to understand the purpose of our existence. We are the trustees of these assets and will be answerable to Him regarding the fair, just and equitable usage of these assets. As mentioned in the Holy Quran.

> *"You are not responsible for people's guidance ˹O Prophet˺—it is Allah Who guides whoever He wills. Whatever you ˹believers˺ spend in charity, it is for your own good—as long as you do so seek the pleasure of Allah.[1] Whatever you donate will be paid back to you in full, and you will not be wronged". Surah Al-Baqarah (2:272)*

Islam is a system of belief that guides not only the man's relationship with his Creator but also aims to provide its masses with a set of laws that regulates the entire way of life. Human beings have been blessed with divine principles that contain a complete code of law not only to guide their personal life but also help them transact their business in an orderly manner in which justice and equality are ensured and no one is allowed to get the benefit at the cost of the other. The two sources of guidance for Muslims are Quran and Sunnah. Every aspect of life has been guided which includes man's relation with his Lord, and community and left a wide area of human activities to man's rational judgment where he can make decisions on the basic guidelines provided by ALLAH. Allah requires us to follow these commands in the way they are revealed and cannot be violated merely on the grounds of one inner desire or one own rational judgment. Therefore, all human activities should be performed within the limits prescribed by Him. ALLAH requires obedience from His slaves not only in worship but also in socio-economic activities and requires His slaves to work for collective benefits.

## 1.2 Prophet Muhammad (ﷺ) Khaataman Nabiyyeen حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ as Trader

Allah S.W.T created human beings and entrusted them with wealth, human beings as trustees for Allah S.W.T. are required to carry out their responsibilities according

to the guidelines prescribed by Him. Business and trade were prevalent before Islam and people used to travel from one place to another for buying and selling.

Muhammad (S.A.W.)حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيّٖنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ , the last prophet of Allah, was sent by Him for the guidance of mankind. Prophet Muhammad (ﷺ) Khaataman Nabiyyeen حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيّٖنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ was a shepherd, an arbitrator, a community leader, and a merchant himself. He was born in the Hashim family in the Quraish tribe of Makkah. Prophet Muhammad (ﷺ) Khaataman Nabiyyeen after the death of his grandfather was raised by his uncle Abu Talib, who was a trader himself and guided him about trade as well. In his twenties, he became the commercial agent of a rich widow whom he married later. Islam since its inception considered private property, business enterprise and profit to be legitimate. If the trader is fulfilling his religious duties, he is rewarded and allowed to carry on his worldly activities. The connection between religion and commerce is further illustrated by the fact that Islam was spread in many parts of the world (Africa and the Far East) by Muslim merchants. In the prophet's era, the revenues were dependent heavily on trade and revenue from pilgrims. Later Makkah was considered as the lucrative trade route.

At the time of Prophet Muhammad S.A.W. حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيّٖنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ trade activities were being practised; he led the foundation of the Islamic financial system 1400 years ago. He proposed a financial system based on Islamic principles to ensure the well-being of individuals and equal distribution of wealth. Makkah was a barren land and faced scarcity of water therefore it was considered unfit for cultivation. Therefore, Arabs were dependent on commerce and trade as a source of revenue generation as well. Their commercial activities were not limited to their land, but their caravan trade was extended to Syria, Iraq, Egypt, Ethiopia etc. With time the commercial activities of Arabs extended so much that they were regarded as a trading nation.

The importance of the trade convoys is evident from the fact that ALLAH has revealed a Surah Al-Quraish to acknowledge the services of the people of Quraish towards the Kabah. Their business towards Yemen in winter and towards Syria in summer was considered a blessing for them from ALLAH. During the battle of Badr, a huge caravan was led by Abu Sufyan which consisted of one 1000 camels and returned after earning double the investment (profit of almost 100%). Caravans of such huge size worked as a collective enterprise and the capital of these caravans of Makkah was raised by the contributions from traders of the different families. They either had money or had borrowed from others to earn profit. Tribes of Arabia used to take interest-based loans from each other, one tribe used to charge interest from the other tribe and the other tribe would pay them the interest. It was a common practice that people having more information about business transactions always wanted to get more benefits at the cost of the people not having sufficient

information, secondly, in those times people who didn't have ample resources were exploited and people having excess money used to lend needy people and make benefit out of the amount lent and the time for which the amount was being lent. This is referred to as the Ribah which is defined as, "an excess which, in an exchange or sale, accrues to the lender without the return of any equivalent counter-value, substitute or recompense to the other party".

The tribes of Arabia used to borrow from other tribes for commercial enterprises and productive purposes, in addition to loans for consumption purposes. An example of loan for commercial enterprises is evident from the following authentic Hadith of Prophet Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ

"During his time there was an Israelite who borrowed 1000 dinar from another person to finance his commercial enterprise. The Israelite, after borrowing the money left for the sea voyage and on maturity, had earned so much amount that he had offered to pay creditors back more than the amount of the loan to which he denied and took back just the principal amount. (Sahih Bukhari Hadith No. 2291).

In the time of Prophet Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ, one of his companions Zubair Bin Awam (R.A.) was amongst the richest people. He was famous for his honesty. People on account of his creditability used to keep their money with him in trust. However, he used to accept these deposits in the form of loans instead of trust. It was for the benefit of the depositor that if the amount is treated as a loan, the amount had to be repaid, in any case. However, if that same amount is deposited in the trust, the amount would not have to be repaid in case of theft or fire. Sayyidina Zubair (R.A) used to invest these deposits from people (obtained in the form of loans) in trade. The way he used to receive deposits and invest them in trade is very similar to present-day private banks (Ribah Judgement).

Islamic banking, as we witness today did not exist during the time of Prophet Muhammad (S.A.W) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ. However, during his time the foundations and the basic principles of Islamic finance were laid down in the Quran and Sunnah. These principles have now been considered the basis of modern Islamic finance. The basic concepts and principles established by Prophet Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ during his era include the prohibition of Ribah, profit and loss sharing, asset-based financing, ethical investment, zakat, charity, and honesty and transparency in transactions. During his time, all economic activities, trade, and commerce were conducted following these Islamic principles.

## 1.3 Islamic Economic System

Islamic economic system is economic based on Shariah principles derived from the Quran and Hadith. Islamic economic system promotes the distribution of wealth, equity and justice while adhering to the ethical and moral values of Islam. Unequal distribution of wealth leads to monopolies and results in a concentration of wealth in the hands of a few rich members. In the Islamic economic system, the importance of market forces is not denied. The existence of private property, profit motives and business enterprises are well appreciated provided the rights of one party are not fulfilled at the cost of the other party. Islam discourages giving economic decision-making to one section of the society negating the rulings of Shariah as this will lead to imbalances in the society. Interest, gambling, and speculative activities tend to aggravate the problems. Making money by undertaking illegal and prohibited activities also causes injustice and unequal distribution of wealth. These factors ultimately disrupt the market forces and hinder their natural mechanism. The capitalist economy encourages profit motives and the occurrence of those economic activities that are not even in the interest of the whole economy merely because they are in favour of a few influential sectors. The existence of authority promoting justice and equity is denied in such a system. In capitalist economies, market forces are not allowed to work naturally. Unjust activities cannot be eliminated unless and until the existence of divine authority is recognized. Islam has recognized market forces, private ownership and profit motives to the extent that they remain within the restrictions imposed by the Shariah. These restrictions on economic activities such as prohibition or Ribah, gambling, hoarding, unethical activities, and speculative transactions help the economy remain balanced ultimately promoting justice and equality.

### 1.3.1 Key Features of the Islamic Economic System

Islamic economic system includes the following key features.

**i. Shariah Compliance**

The Islamic economic system is based on the rules of Shari'ah, which come from the Quran and the teachings of Prophet Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ. All economic activities must comply with Islamic law, ensuring ethical conduct, social justice, and adherence to the Maqasid-e-Shari'ah, the objectives of Islamic law.

**ii. Prohibition of Riba (Usury/Interest)**

Interest-based transaction, one of the most important features of capitalism is regarded as an evil in the economic philosophy of Islam. In these transactions, the provider of the capital is entitled to receive a fixed rate of return on his investments whether the business is making a profit or not. Islamic economic system disregards

such kind of trading and requires Islamic rulings to be made applicable not just as a moral teaching but as a law of the land.

**iii. Wealth Distribution and Zakat**

To achieve the economic well-being of the people, the Islamic economic system requires that the wealth should not remain concentrated among a few individuals or groups of people, but it should be transferred and shared throughout the society. Zakat (obligatory charity), Sadaqah (voluntary giving), and other forms of wealth redistribution mechanisms help to create such a society where the basic needs of all individuals are fulfilled, and where the disparity among the social classes should be reduced to maintain social harmony among the masses.

**iv. Ownership and Property Rights.**

To ensure the fair distribution of wealth among the heirs of an individual after his death. Islam has prescribed a system of inheritance laws. These laws are designed to discourage the concentration of wealth in the hands of a few heirs and protect the rights of spouses, children, parents, and all related parties.

**v. Ethical Investment and Business Practices**

Islam encourages all such economic activities related to trade and commerce that promote social welfare, economic justice, and equal distribution of wealth. All such activities that lead to disparity among the masses are strictly prohibited. Islam requires investments and businesses to be conducted based on transparency, fairness, and honesty. All business practices that lead to unjust accumulation of wealth due to fraudulent activities, dishonesty, and deception are discouraged.

**vi. Prohibition of Haram (Forbidden) Activities.**

Transactions characterized by excessive uncertainty or speculation are forbidden. Contracts are required to be transparent, with explicitly defined terms and conditions, aimed at preventing exploitation and promoting fair dealings.

**vii. Risk Sharing**

Islamic finance advocates for the sharing of risks and profits among stakeholders, thereby fostering a fairer distribution of risk and promoting collaboration and partnership in economic endeavours.

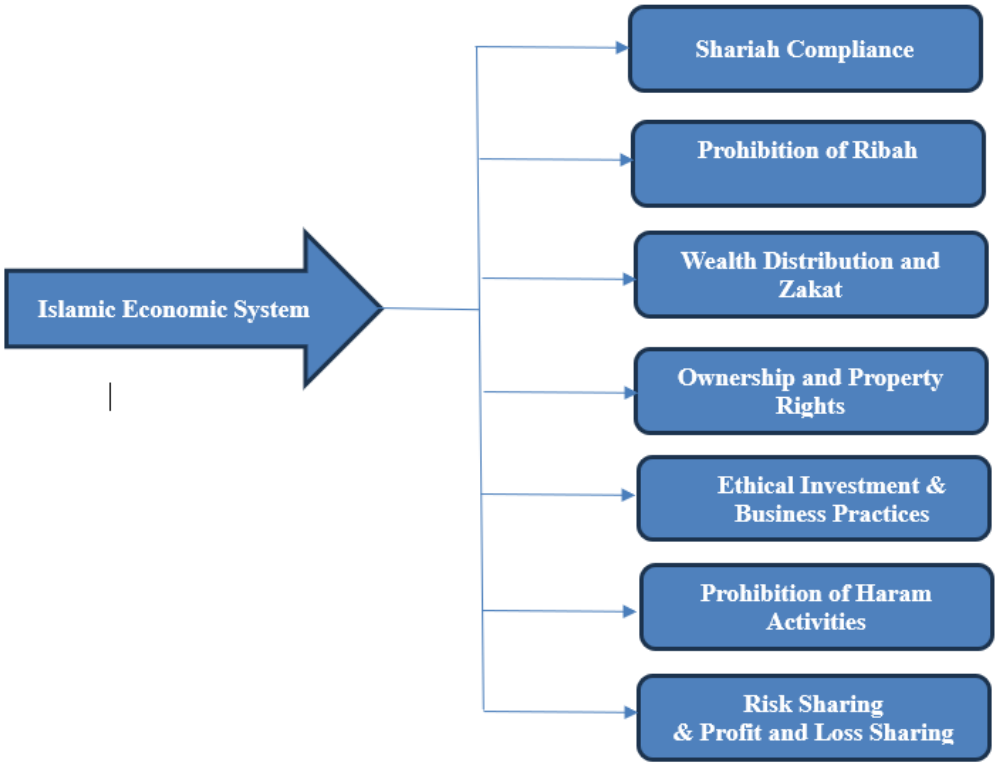



**Figure 1.1: Islamic Economic System**
**Source: Self-created by Author**

## 1.4 Difference Between Capitalist and Islamic Economic Systems

Islamic economic system and capitalism are economic frameworks based on distinct principles, The Islamic economic system is guided by Shariah principles which are derived from the Quran and Sunnah. It aims to create a system based on the moral and ethical values of Islam. Capitalism on the other hand, is a system driven by profit motive and private ownership of means of production. It is a system based on individual self-interest and is not guided by any divine rulings. The two systems differ in almost every aspect as discussed below:

### i. Wealth Distribution

Islamic economic system encourages wealth distribution and economic justice to remove economic disparity in the system. Mandatory almsgiving and voluntary Sadaqat along with other measures are being practiced to ensure equality in society. Capitalism on the other hand promotes wealth accumulation based on profit motives. Individuals and corporations are allowed to accumulate wealth based on their ability to make profits. These profit motives lead to income inequality and wealth concentration among specific segments of the population.

**ii. Ownership and Property rights**

Islam encourages private ownership but imposes certain restrictions on the ownership and property rights to prevent the concentration of wealth. Capitalism, on the other hand, is an advocate of property rights. Individuals are allowed to own and control resources with relatively few restrictions. Economic decisions are influenced by private ownership and profit motives. The restrictions are imposed by human beings themselves which can be influenced through democratic legislation.

**iii. Interest and Finance**

Islamic economic system promotes interest-free transactions, and profit and loss sharing. It prohibits interest (Ribah) on every level. Capitalism, on the other hand, does not restrict charging of interest and promotes interest-based dealings.

**iv. Market Regulation and Intervention**

Islamic economic system requires a system to be based on transparency, fairness, and ethical business practices. It recognizes market forces and does not allow government intervention in controlling the market forces and the overall economy. In Capitalism, on the other hand, the market can be manipulated by government interventions. Market forces are not allowed to work naturally as they work in the case of free competition not in the case of monopolies. Here the natural process of demand and supply can be affected by self-interest.

**v. Profit Motives**

Islamic economic system allows profit earning provided it is generated through permissible activities. Profit should be according to the inherent risk in the investment. Islam discourages profit generation through activities such as gambling, speculation, and through unlawful (prohibited) activities. Profit motives in capitalist economics are the sole purpose of the economy. Profit maximization is regarded as the prerequisite of economic growth. These self-interest-based profit motives lead to disruption of market forces and create monopolies.

**vi. Ethics and Values**

Islamic economic system is based upon the foundation of Shariah principles which promote justice and equity among the masses to ensure economic activities based on Islamic ethical values. In the Islamic economic system, investments are made on humanitarian grounds as well and people may suffer worldly losses with an expectation of getting higher rewards in hereafter. Capitalist economics are not based on any inherent values, their objective is to ensure efficient allocation of resources to achieve individual and corporate profits.

**Table 1.1: Difference Between Capitalist and Islamic Economic Systems**

| Aspect | Islamic Economic System | Capitalism |
|---|---|---|
| **Wealth distribution** | Encourages wealth distribution and economic justice through measures like almsgiving and voluntary Sadaqat. | Promotes wealth accumulation based on profit motives, leading to income inequality and wealth concentration. |
| **Ownership and Property** | Encourages private ownership with restrictions to prevent wealth concentration. | Advocates private ownership with few restrictions, influencing economic decisions based on profit motives. |
| **Interest and Finance** | Promotes interest-free transactions and profit-sharing, prohibiting interest (Ribah). | Imposes no restrictions on interest, allowing interest-based dealings. |
| **Market Regulation** | Recognizes market forces, prohibits government intervention, and emphasizes fairness and ethics. | Allows government intervention, potentially manipulating market forces and distorting natural competition. |
| **Profit motives** | Allows profit earning through permissible activities with consideration of inherent risks. | Regards profit maximization as the primary goal, potentially leading to the disruption of market forces. |
| **Ethics and Values** | Based on Shariah principles, promoting justice, equity, and investments on humanitarian grounds. | Lacks inherent values, focusing on resource allocation for individual and corporate profits. |

## 1.5 Objectives of Wealth Distribution in Islam

The system of distribution of wealth has been laid in the Islamic economic system to attain the following three objectives.

a. The establishment of such a natural and practicable system of economy that enables every individual to work and perform according to his abilities, and preferences which helps him in fruitfully performing his tasks. This system is only possible when individuals in society are aware of their responsibilities towards others. The relationship between employer and employee should be based on mutual understanding and all the resources are being utilized properly. The natural forces of demand and supply are allowed to work out without any interruption.

*"Is it they who distribute your Lord's mercy? We ˹alone˺ have distributed their ˹very˺ livelihood among them in this worldly life and raised some of them in rank above others so that some may employ others in service. ˹But˺ your Lord's mercy is far better than whatever ˹wealth˺ they amass. Surah Az-Zukhruf (43:32)*

b. Everything belongs to Allah and He is the only one who decides the wealth of everyone. He has laid down the rights of the poor, helpless, orphans, needy and destitute in the wealth of those who participated directly in the production

of the wealth. Allah has made it obligatory upon all the producers of wealth to pass on the share of these people out of their wealth.
*"In their wealth, there is a known right for those who ask for it and those who have need for it." Surah Al-Ma'arij (70:24-25)*

c. Wealth should be circulated in society instead of being held in the hands of the rich people. Islam has not allowed any individual to exercise his unnecessary power over the primary sources of wealth. Every individual has been given this right to make use of these sources according to his capabilities and derive benefit out of them without creating a monopoly over these resources.
*"……so that wealth may not merely circulate among your rich." Surah Al-Hashr (59:7)*

## 1.6 Evolution of Modern Islamic Banking System

The foundation of Islamic banking laid down in the prophet era has experienced significant growth over the years, across different regions and countries. The underlying Shariah principles of the Islamic economic system have remained unchanged since their inception over 1400 years ago. Present-day developments in Islamic banking have been attributed to these principles. The developments in Islamic banks date back to the year 1940 when in the Indian sub-continent, loan cooperatives based on religious and ethical ideas were originally started. In 1950, in Pakistan, rural landlords created a credit network based on interest-free loans. During the 1960s to 1970s, many Muslim countries particularly from Middle East started taking a serious step towards aligning their financial system with Shariah-based principles.

### i. Early Efforts

In 1963, in Malaysia, a fund was created as a savings corporation which helped pilgrims save their money for performing the religious obligation of Hajj. Later it was named as pilgrims management and fund board or Tabung haji. The savings were invested according to the Shariah principles. The first modern Islamic bank "Mit Ghamr Savings Bank" was founded in 1963 in Egypt. This bank was established by Ahmed El Najjar and Dr. Ahmed El Shiekh to provide financial services to customer based on Islamic principles. The Mit Ghamr Savings Bank was created to eliminate interest-based transactions and promote investment activities in compliance with the Shariah principles. The establishment of Mit Ghamr Bank laid down the foundation of modern Islamic baking practices. From the 1970s to the 1980s, financial institutions based on Islamic banking were established across different parts of the world. The establishment of the Islamic Development Bank in 1975 in Saudia Arabia paved the way for the foundation of Islamic banks at the global level. The demand for Shariah complaint products increased which has further driven the development of more Islamic financial instruments. After the Islamic Development Bank, Dubai Islamic Bank and Kuwait Finance House came into being. Islamic banks gained global expansion during the 1980s to 1990s. Islamic banking institutions started expanding branches and subsidiaries across different countries. The year 2000 marked the

expansion of Islamic banking in the Western financial markets. London became the hub of Islamic financial services. Banks in Western countries started developing products based on Shariah principles.

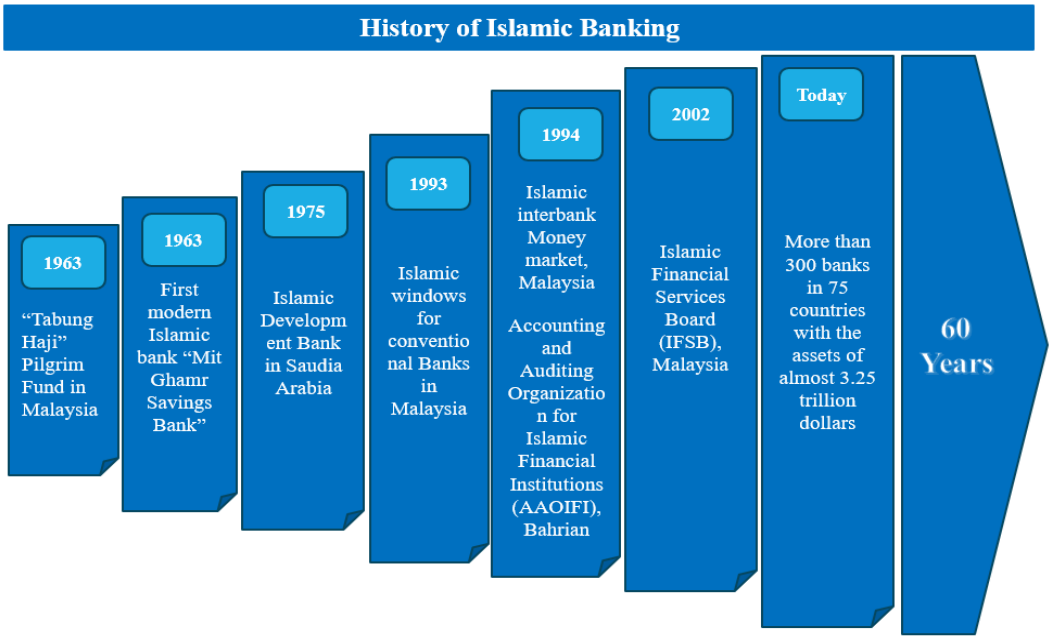



**Figure 1.2: History of Islamic Banking**
**Source: Google Search/Self-created**

### ii. Modern Islamic Banking

Islamic financial institutions offer a wide range of financial products and instruments that are based on Shariah principles and are designed to meet the needs of the customer seeking shariah-based returns. It includes profit-sharing modes such as Mudarabah and Musharakah (Joint venture), Sale based modes such as Murabah (cost plus financing), Ijarah (lease financing), Salam (agriculture financing), Istisna (industrial financing), Sukuk (Islamic Bonds). During the period of expansion and growth, Islamic banks faced many challenges related to regulations and standardization. To overcome these challenges and to ensure the acceptability and credibility of Islamic financial institutions, organizations like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) were established. The modern Islamic banking system is adopting innovation in products and services and diversification in their activities by introducing takaful (Islamic insurance), Islamic microfinance, and shariah-based asset management. Further advancement in Islamic banking includes a listing of Sukuk (Islamic bonds) on international exchanges, participating in global financial markets transition and development of Islamic mutual funds.

### iii. Islamic Banking Today

Today the continued expansion and influence of Islamic banking in Pakistan worldwide emphasizes its importance in providing diverse financial services and contributing to economic development.

### a. Islamic Banking in Pakistan

The Islamic banking sector in Pakistan consists of 22 institutions, comprising 6 full-fledged Islamic banks and 16 conventional banks with specialized Islamic banking branches with the total of 5101 Islamic banking branches. Furthermore, 1,916 Islamic banking windows are providing Shariah-compliant banking services. The assets of the Islamic Banking Industry (IBI) reached PKR 9,235 billion by the end of March 2024.

**Table 1.2: Status of Islamic Banking in Pakistan**

| Metric | Value |
|---|---|
| Full-Fledged Islamic Banks | 6 |
| Conventional Banks with Islamic Banking Branches | 16 |
| Total Branches | 5,101 |
| Islamic Banking Windows | 1,834 |
| Assets (End of June 2023) | PKR 9,235 billion |

### b. Islamic banking Performance worldwide:

As of the conclusion of 2022, Islamic banking assets have reached a significant milestone, totalling USD 3.25 trillion, compared to USD 3.06 trillion in 2021. Islamic banking assets accounted for 69.3% of the total value of global Islamic finance and banking assets, showing a slight uptick from the previous year's 68.7%. Throughout 2022, Islamic banking experienced robust growth, with assets expanding by 6.9%. It is noteworthy that there are 15 jurisdictions where Islamic banking holds systemic importance. This designation indicates that the total Islamic banking assets in these countries comprise more than 15% of their respective total domestic banking sector assets. Collectively, these jurisdictions account for USD 2,071.9 billion, representing a substantial 92.1% of the total global Islamic banking assets.

**Table 1.3: Status of Islamic Banking Worldwide**

| Metric | Value |
|---|---|
| Total Islamic Banking Assets (2022) | USD 3.25 trillion |
| Total Islamic Banking Assets (2021) | USD 3.06 trillion |
| Percentage of Global Islamic Finance Assets (2022) | 69.3% |
| Percentage of Global Islamic Finance Assets (2021) | 68.7% |
| Growth Rate of Islamic Banking Assets (2022) | 6.9% |
| Systemically Important Jurisdictions (Total) | 15 |
| Total Assets in Systemically Important Jurisdictions | USD 2,071.9 billion |
| Percentage of Global Islamic Banking Assets (Systemic) | 92.1% |

## SUMMARY

The unit talks about how Islamic beliefs relate to money matters. It starts by looking at how Muslims believe in following divine guidance and how Prophet Muhammad (P.B.U.H) Last Prophet was also involved in the trade. It explains the basic ideas behind Islamic economics and compares them with how capitalism works, focusing on how Islam aims to share wealth fairly. It also talks about how Islamic banking has changed over time, showing how it has grown and why it's important today. By reading this unit, you'll learn a lot about Islamic economics and banking, which are based on ideas like fairness, justice, and helping society.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions:
   i. What is divine guidance?
   ii. What is wealth distribution in Islam?
   iii. State the key features of the Islamic economic system.
   iv. What is risk sharing?
   v. What is Shariah Compliance?

2. Write long notes on the following questions:
   i. Evolution of Modern Islamic Banking System
   ii. Difference Between Capitalist and Islamic Economic Systems
   iii. Prophet Muhammad P.B.U.H حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ as Trader

3. Please fill in the blank spaces.
   i. The importance of the trade convoys is evident from the fact that ALLAH has revealed a Surah…… to acknowledge the services of the people of Quraish towards the Kabah.
   ii. Prophet Muhammad S.A.W. حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ led the foundation of the Islamic financial system……. years ago.
   iii. Islam has recognized market forces, private ownership and profit motives to the extent that they remain with the restrictions imposed by……
   iv. The establishment of ……. bank laid down the foundation of modern Islamic baking practices.
   v. The Islamic economic system is based on the rules of Sharia, which come from …… and ……

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**Unit–2**

# ISLAMIC BANKING PRINCIPLES

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## INTRODUCTION

In this unit, we will study the fundamental concepts related to Islamic finance and banking. We will first explore the key terms such as Shari'ah, Aqidah, Fiqh, Ibadat, and Muamalat, understanding their significance in the context of Islamic economics. Furthermore, we will examine the sources of Shariah law, including Ijma, and Qiyas, to comprehend how Islamic principles are derived and applied. This unit will also address the concept of Ribah, its prohibition in the Quran and Hadith, and its implications for financial transactions in Islam. Additionally, we will analyze the framework and principles of Islamic banking, highlighting major differences between Islamic and traditional banking systems.

## OBJECTIVES

At the end of this unit, you will be able to,

i. Understand the foundational concepts of Shariah, Fiqh, and Aqidah in Islamic finance.

ii. Aanalyze the sources of Shariah law, including Ijma, and Qiyas, and their role in Islamic jurisprudence.

iii. Understand the concept of Riba, its types, and the prohibition of Riba in Islamic teachings as outlined in the Quran and Hadith.

iv. Explore the framework of Islamic banking and its underlying principles.

v. Compare and contrast Islamic banking with traditional banking systems, highlighting major differences in their approaches and practices.

## 2.1 Concepts of Shariah

### 2.1.1 What is Shariah

Shariah means "way or a path". Shariah an Arabic word (شريعة) means "the path to be followed". In Islamic terminology, shariah means a legal system or law of Islam. Shariah refers to the system of religious and moral principles that govern the lives of Muslims.

Allah has sent messengers and books to the people to guide them to the right path. A path that leads them to success in this world and the hereafter. The holy prophet Muhammad SAW was the last messenger, and Shariah represents the ultimate manifestation of His divine message as mentioned in the Holy Quran.

> *Today I have perfected your faith for you, completed My favor upon you, and chosen Islam as your way. Surah Al-Maida (5:3)*

### 2.1.2 Importance of Shariah

The purpose of the creation of human beings is servitude (being a servant) to the creator. Without the guidance of Allah, it would not be possible for human beings to meet this purpose. Muslims are expected to follow Islamic laws in every aspect of life. Shariah governs the personal, religious, marital, social, moral, political and economic duties and obligations of the Muslims. No aspect of life is left unaddressed in Shariah.

> *It is not for a believing man or woman—when Allah and His Messenger decree a matter—to have any other choice in that matter. Indeed, whoever disobeys Allah and His Messenger has clearly gone ˹far˺ astray. Surah Al-Ahzaab (33:36)*

### 2.1.3 Components of Shariah

Shariah consists of three main components which include Aqidah, Fiqh, and Akhlaq.

#### *(a) Aqidah*

Aqidah means the fundamental belief or creed in Islam. These are the pillars upon which the foundation of a faith of Muslim is laid. There are five pillars of Aqidah which include.

**i. Belief in Allah**

Tawhid is the basic pillar of Islam which means that there is no God, but Allah and he alone is the one who deserves worship and obedience. He has no partners, associates, or children. The belief in the oneness of Allah is an important part of Muslims' faith.

**ii. Belief in Prophets**

Allah has sent messengers for the guidance of mankind throughout the existence of human beings. Prophets are sent to the people to convey Allah's message and to lead them to the right path. Muhammad S.A.W. حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ being the last messenger after which there will be no prophet. Belief in earlier prophets and Prophet Muhammad (S.A.W.) is an integral part of the faith of the Muslims.

**iii. Belief in Books**

Allah sent books for the guidance of humanity. The Quran is the last book which testifies to the revelation of previous books and scriptures which include Taw'rat, Zabur, and Injeel. Belief in Quran, the holy book for the guidance of humanity is part of the faith of the Muslims.

**iv. Belief in Angels**

Angels are the celestial beings created by Allah. They are countless and perform every task assigned by Allah. Belief in angels is also important part of Muslims' faith.

**v. Belief in the day of Judgement**

Muslims believe in the day of Judgment when their deeds will be weighed, and the reward and punishment will be given according to their deeds.

**vi. Belief in fate**

The belief that nothing can happen in this world without the will of Allah. The faith of the Muslims is incomplete without the belief in destiny (or fate).

### *(b) Fiqh*

The second important element is Fiqh, an Arabic word that means "deep understanding." Fiqh refers to Islamic jurisprudence or the understanding and application of Sharia law. It is derived from the Quran and the Hadith (the sayings and actions of Prophet Muhammad S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ, and it encompasses all aspects of a Muslim's life, including rituals, morals, social legislation, and legal issues. Fiqh guides behaviour, attitudes, and ethics in undertaking various practices and activities, which are divided into two categories: worship (Ibadat) and social dealings (Muamalat).

**i. Ibadat**

Ibadat governs the relationship of Muslims with their creator. It includes the religious duties and rituals that Muslims are expected to follow, such as prayer, fasting during Ramadan, and hajj, giving to charity (Zakat), and recitation of the Quran.

**ii. Muamalat**

Muamalat is linked with the man-to-man relationship which governs the social, economic, political, and legal activities of human beings. These are the rules and regulations related to transactions, contracts, and interpersonal relationships in daily life. e.g. Buying and Selling**,** Marriage and Family Law**,** Criminal law**,** employment and labour contracts**,** and Inheritance laws.

***(c) Akhlaq***

The third element is Akhlaq which provides the ethical and moral guidelines within which the behavior, attitudes and conduct of the Muslims can be determined. It includes ethics, and personal conduct emphasizing virtues like honesty, compassion, and kindness.

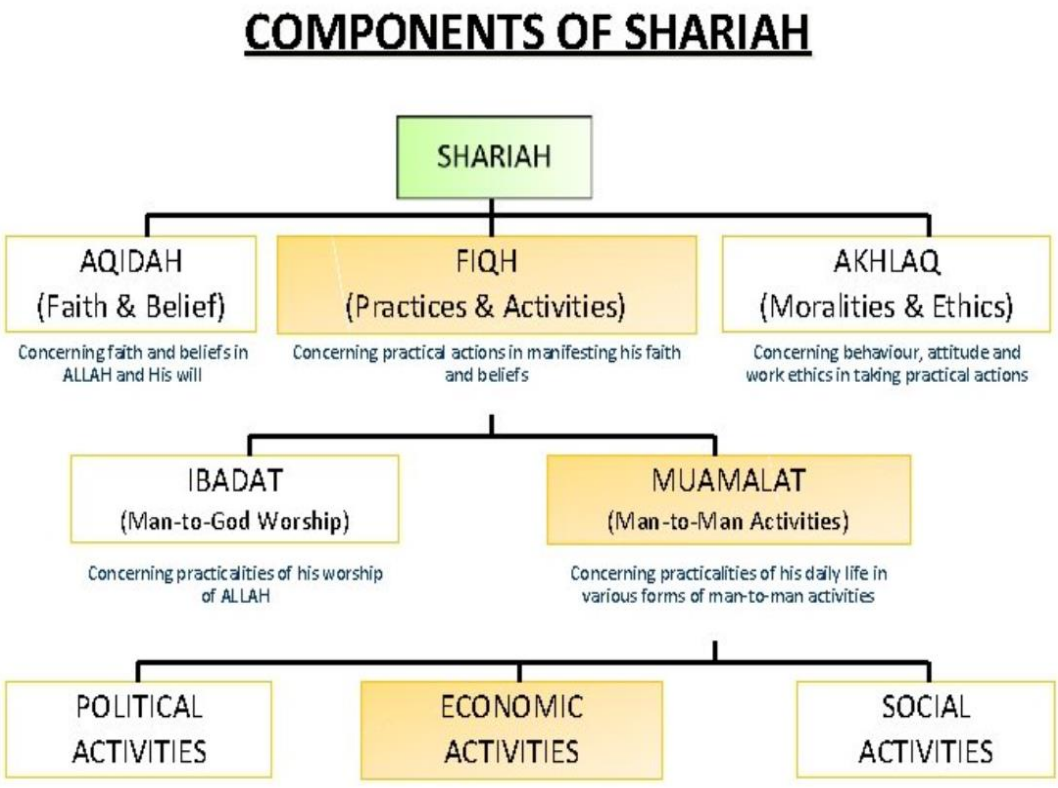



**Figure 2.1: Components of Shari'ah**
**Source: Google**

### 2.1.4 Sources of Shariah

Shariah is based on laws and these laws are extracted from the four sources which include.

i. **The Quran:** The sacred book of Muslims, and the primary source of Shariah as it has direct words of Allah. It has been revealed by Allah on Prophet Muhammad

ii. **Sunnah:** Sunnah refers to the life and practices of prophet Muhammad (S.A.W)حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ and his life example. Things he said, did or agreed to. Sunnah also clarifies the details of the Holy Quran; Prophet Muhammad was a role model for the entire mankind and his obedience is regarded as the only means to please Allah and to attain Jannah.

iii. **Ijma:** The consensus of the opinion of the companions of the prophet Muhammad or the Muslim jurists of the first three centuries of hijra. Ijma is an agreed-upon decision that is used as a source of shariah only when a problem in being encountered which was not existent at the time of prophet Muhammad SAW or which cannot be found in the Quran and Sunnah.

iv. **Qiyas:** Qiyas means judging by comparing with something. It is an analogy from Quran, sunnah and ijma reasoning and legal precedence to decide new case law, and can be used as a source of Shariah when the solution is not in other sources.

### 2.1.5 Objectives of Shariah

The objectives of Shariah, also known as " Maqasid-e-Shariah" in Arabic, refer to the higher purposes and goals behind Islamic law. These objectives are derived from fundamental Islamic principles and aim to promote human welfare, justice, and the preservation of essential rights. Any activity/contract that goes against the Maqasid-e-shariah is considered invalid. Maqasid-e-Shariah guide Muslims to undertake activities that are concerned with the following five objectives.

i. **Preservation of Din (Religion):** Preservation of Din is concerned with ensuring the protection and preservation of the Islamic faith and practices.

ii. **Preservation of Nafs (Life):** Preservation of Nafs is concerned with safeguarding the lives and well-being of individuals, promoting health, and safety, and the prevention of harm to the lives of the individuals.

iii. **Preservation of Nasl (Progeny):** Preservation of Nasl is concerned with protecting the family structure, promoting marriage, and ensuring the well-being and rights of children.

iv. **Preservation of Aql (Intellect):** Preservation of Aql is concerned with encouraging the growth of intellect, promoting education and critical thinking, while discouraging actions that undermine cognitive abilities.

v. **Preservation of Mal (property):** Preservation of Mal is concerned with Safeguarding ownership rights, promoting fair trade and commerce, and preventing exploitation and unjust economic practices.

## 2.2 Islamic Banking Framework

Islamic banking is based on the framework based on the rule of shariah and it is designed to comply with the Islamic principle.

> *"The International Association of Islamic Banks (IAIB) defined Islamic banking as a financial institution that adheres strictly to the rules of Islamic Shariah in the fields of finance and other dealings. The Bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious spirit among the people".*

### 2.2.1 Islamic Banking Principles

Shariah-compliant finance is based on seven distinct principles. These principles include.

#### *2.2.1.1 Prohibition of Riba*

Riba is an Arabic word which means increase, addition, predetermined or fixed. Riba is defined as "the unlawful gain obtained from unequal exchange of values in any transaction". Riba is generally translated as usury or interest in the Quran and Hadith.

***Classification of Riba:***

Riba is divided into two types.

**i. Riba Al Nasi'ah**

It is the real and primary form of Riba and the most relevant form of Riba for banking. Riba Al-Nasi'ah refers to the excess amount earned from a loan transaction. It is a form of Riba which is created from loan transactions i.e. the borrower pays back the loan amount plus interest. Riba Al- Nasiah is also known as Riba Al- Jahiliyya, Riba Ad-Duyun, Riba Al-Qardh.

Usmah bin Zaid Narrated that the Messenger of Allah said:

> *"There is no Riba except in credit.' (Sunan an-Nasa'i - 4580)*

Riba Al-Nasi'ah may include one of the following scenarios:

a. When a borrower takes a specific sum for a certain period under agreed terms, they must repay more than the principal amount or loan.
b. When a seller sells a product with a deferred payment period, and the purchaser fails to pay within that period, the period is extended by increasing the selling price or debt amount.

**ii. Riba Al Fadl**

Ribah Al Fadl is created from trade. It is defined as "the excess compensation without any consideration resulting from a sale of goods". Riba Al-Fadl is also known as Riba Al-Buyu and Riba Al Bai.

Following the revelation of verses related to the prohibition of Ribah, the Holy Prophet, S.A.W. حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ also prohibited some other transactions that were not previously recognized as Riba. He believed that, given the commercial environment of the time, certain barter transactions could lead people to engage in Riba. The Arabs often used commodities such as wheat, barley, and dates as a medium of exchange to purchase other items. Treating these commodities as a form of currency, the Holy Prophet S.A.W. issued the following directive:

Ubada ibn al-Samit narrated that the Prophet, peace be on him, said:

> *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand" (Muslim).*

This implies that when wheat is exchanged for wheat, the quantities on both sides must be identical. If the quantity on either side is greater or lesser than the other, the transaction constitutes Riba. In the Arab tribal system, these commodities functioned as money, so exchanging one kilogram of wheat for one and a half kilograms of another wheat would be equivalent to exchanging one dirham for one and a half dirhams.

***Prohibition of Riba in the Quran***

The prohibition of Riba appears in the Qur'an in four different stages and revelations.

**i. First Stage**

In the First Stage which was revealed in Makkah.

> *That which you give as an interest to increase the people's wealth increases not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold. Surah al-Rum (30:39)*

**ii. Second Stage**

In the second stage, the verses are revealed in the early Madinah period.

> *And for their taking Riba although forbidden for them, and their wrongful appropriation of other people's property, we have prepared a painful doom for these disobedient persons. However, we will give a great reward to those among the Jews) who are clear-minded about the truth, without a grain of*

*doubt, and who believe in the Quran and all other revealed books, establish salah, give zakat, and believe in Allah and the day of judgment. Surah al-Nissa (4:161-162)*

**iii. Third Stage**

The third revelation was around the second or third year after Hijrah when *Riba* was explicitly considered prohibited for Muslims.

*O believers take not doubled and re-doubled riba, and fear Allah so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey Allah and the prophet so that you get mercy" Surah Aale-Imran (3;130-132)*

**iv. Fourth Stage**

The fourth revelation regarding Riba was near the completion of the Prophet's mission.

*Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist may have what has already passed, their case being entrusted to God, but those who revert shall be the inhabitants of the fire and abide therein forever. God deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner. Those who believe, perform good deeds, establish prayer and pay the zakat, their reward is with their Lord; neither should they have any fear, nor shall they grieve. O believers, fear God and give up the interest that remains outstanding if you are believers. If you do not do so, then be sure of being at war with God and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice, nor should you be subjected to it. If the debtor is in difficulty, let him have respite until it is easier, but if you forego out of charity, it is better for you if you realize. And fear the Day when you shall be returned to the Lord and every soul shall be paid in full what it has earned, and no one shall be wronged. (Surah al-Baqarah, 275-281)*

***Prohibition of Riba in Hadith***

From Jabir: The Prophet, May Peace Be On Him حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ,

*"Cursed the receiver and the payer of interest, the one who records the transaction and the two witnesses to the transaction and said: "They are all alike [in guilt]" (Muslim)*

**i. Consequences of indulging in Riba**

From Abu Hurayrah: The Prophet, Peace Be On Him حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ, said:

> *"On the night of Ascension, I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest" (Ibn Majah)*

From Abu Hurayrah: The Prophet, Peace Be On Him, حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ said:

> *"God would be justified in not allowing four persons to enter paradise or to taste its blessings: he who drinks habitually, he who takes Riba, he who eats an orphan's property without right, and he who is undutiful to his parents" (Mustadrak alHakim)*

**ii. Creditor and Debtor relationship**

From Anas ibn Malik: The Prophet, Peace Be On Him, حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ said:

> *"When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually". (Sunan al-Bayhaqi)*

**iii. Forms of Riba in loans and other transactions**

From Abu Sa'id: Bilal brought to the Prophet, Peace Be On Him حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ, some good quality dates whereupon the Prophet asked him where these were from. Bilal replied, "I had some inferior dates which I exchanged for these - two sa's for a sa'" The Prophet said, "Oh no, this is exactly riba. Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive". (Muslim)

***Rationale behind Prohibition of Riba***

Riba is prohibited in Islam as it ruins the social and economic structure of a society.

**a. At the societal level.**

i. Riba promotes selfishness, laziness, indifference, inhumanity, miserliness, greed, and the worship of wealth among the masses.

ii. It destroys the spirit of sympathy, mutual health and cooperation which ultimately affects the brotherhood and unity among the community members.

**b. At the economic level.**

i. Riba leads to the hoarding of money, which ultimately affects the circulation of wealth among the different sections of society.
ii. Small borrowers are left at the mercy of the lenders who trap them in the vicious circle of interest.
iii. Industrial borrowers who take loans from the banks and earn huge numbers of profits transfer small amounts of the interest to the depositors.
iv. It promotes risk aversion in society which ultimately leads to reduced production.
v. Further, it leads to the establishment of the monopoly cartel, which ultimately reduces the gap between the rich and the poor.

### *2.2.1.2 Prohibition of Gharar*

Gharar means uncertainty, hazard, chance or risk. Gharar is the uncertainty associated with the transactions of items whose existence or characteristics are uncertain. Uncertainty is present in the wording of the contract, the subject matter, consideration, and liabilities. Shariah requires Islamic financial transactions to be based on accuracy and transparency and should be free from uncertainty and speculation. It is considered a prohibited element in Islamic finance and commerce because it introduces an element of unfairness or exploitation and goes against the principles of clarity and transparency in contracts and agreements.

In Islamic finance, every contract mandates full transparency for all parties involved. Both parties maintain proper control and complete information, with speculation strictly prohibited to protect the vulnerable and eliminate injustice, fraud, and deception. Parties involved must have prior knowledge about

a. terms and conditions of the contract,
b. the price of products,
c. commodity to be delivered,
d. the date and time of delivery, and
e. the mode of payment.

Gharar can be understood by the following examples.

- Sale of unborn camel baby still in mother's womb
- Flowers before they appear on the plant.
- Milk in the lactose glands.
- Selling fish in the water
- Selling fruit before they ripen
- Two prices in one sale
- Fruits from the tree from mere estimation
- Anyone of the animals from the herd

- Sale of goods that the seller cannot deliver.
- Sale of goods lacking description, sizes, quantity, and price.

### *Type of Gharar*

**i. Gharar Fahish (Major Uncertainty)**

This type of Gharar is intolerable and invalidates the contract, rendering it void. The uncertainty is so significant that it becomes unacceptable, such as the sale of a non-existent object, an object that cannot be delivered, or an object not meeting the agreed specifications.

**ii. Gharar Yasir (Minor Uncertainty)**

This type of Gharar does not invalidate the contract, as the uncertainty is tolerable and considered a normal market phenomenon. Its impact on the economy and society is minimal, such as in unilateral or charitable contracts, gifts, or transactions fulfilling public needs like Bai' Al Salam and Istisna.

### *2.2.1.3 Prohibition of Maysir*

Maysir means Gambling or a game of chance and denotes acquiring wealth such that it deprives others of its rights. It is getting something without putting in any effort. In Maysir something of value has been acquired without earning it and it depends upon the occurrence of an uncertain event in the future. It also includes a game of chance where risk is taken deliberately to obtain large returns e.g., lotteries, casinos etc. Islam has explicitly made Maysir prohibited as shown by the following verse.

> *"O you who have believed, indeed, intoxicants, gambling, [sacrificing on] stone alters [to other than Allah], and divining arrows are but defilement from the work of Satan, so avoid it that you may be successful" Surah Al Maida (5:90).*

### *2.2.1.4 Prohibition of Fraud and Deception (Khilabah and Ghishish)*

It also includes earning income from following practices such as fraud, Deception, Misrepresentation, sale of defective things, and sale of goods with false description. These are the transactions concluded with misinformation and fraud.

### *2.2.1.5 Investment and Financing of Shariah Approved Activities.*

Shariah requires Islamic banks to undertake activities consistent with the Islamic moral value system. Shariah prohibits them from undertaking activities which are against the sanctity of Islam and are harmful to the society or masses in general. They cannot finance or invest in illegal activities such as weapons, gambling services, drugs, wine, and the provision of pork and other unethical or exploitative activities.

The rationale behind the prohibition is that they are a threat to society and harmful to the moral and ethical values. Direct investment in this business is prohibited and the participation in the mutual funds that help these industries to flourish is also prohibited.

#### *2.2.1.6 Risk Sharing*

Rik sharing is the best and the foremost principle of Islamic banking. It requires that the partners share the profit and loss of the venture according to the role or the part played by them in the business it could be the effort or the financial input as well. On the liabilities side, IBs are required to mobilise their deposits based on PLS. Similarly, on the assets side, all financing and investment activities undertaken should be based on risk and return sharing. PLS arrangement, if truly applied, can provide protection to banks during adverse conditions. According to this principle, the returns are not guaranteed.

Islamic banks apply two financial modes that are based on the principle of risk sharing i.e. Mudarabah and Musharakah. In Mudarabah, one party provides the capital while the other party manages the business. Profits are shared according to an agreed-upon ratio, but losses are borne by the bank. Musharakah involves both the bank and the client contributing to the capital and sharing profits and losses based on their contributions. In Islamic banking, profit and loss sharing replaces interest. Instead of charging interest, Islamic banks enter into partnerships with clients, sharing the risks and profits of investments and business activities.

#### *2.2.1.7 Asset-Backed Financing*

Under Islamic principles, money cannot be used as a substitute for capital or assets. Shariah prohibits making money from money in the form of interest payments on loans or deposits. Islamic banking is based on asset-backed financing where financing is provided against tangible assets. Islamic banking transactions are linked to the real economy and backed by real, physical assets. This asset-backed financing reduces interest-based and speculative activities/transactions.

## 2.3 Major Differences in Islamic Vs Traditional Banking

Conventional banks are financial intermediaries operating on interest-based transactions. They “borrow to lend.” They borrow in the form of deposits and lend to earn interest. Whereas Islamic banking is based on partnership. Islamic banking is the alternative for the individual seeking shariah-based returns for their investments. Islamic banks engage in partnerships and collaborative financial arrangements with clients, fostering a sense of mutual benefit and cooperation.

Islamic banks are expected to maintain high ethical and moral standards, and they often have Sharia boards or committees consisting of Islamic scholars who review and ensure the Sharia compliance of their operations. This enhances transparency and accountability. In a nutshell, Islamic banking Promotes financial justice ethical and moral values, reduces the impact of harmful products and practices and ultimately contributes towards the strengthening of the financial system.

The framework of Islamic banking is based on the underlying principles and theoretical background which are distinct from the conventional banks. Following are some major differences between Islamic and conventional banking.

**i. Interest-based transactions.**

- **Islamic Banking**: Islamic banking refrains from interest-based transactions which is explicitly considered prohibited in Islam.
- **Conventional Banking**: Conventional banks are based on interest-based transactions, they mobilize their deposits based on interest and charge interest on loans.

**ii. Risk and Reward Sharing**:

- **Islamic Banking**: Risk and rewards in Islamic banking are shared between the partners (bank and the client) in profit-and-loss sharing-based modes such as Mudarabah and Musharakah. Islamic banking focuses on risk sharing.
- **Conventional Banking**: Conventional banks charge a fixed interest rate which is predetermined without any consideration of the results or outcomes (success or failure) of the borrower's venture. The risk is transferred to the other party instead of sharing.

**iii. Asset-Backed Financing**:

- **Islamic Banking**: Islamic bank's financing is backed by tangible assets ultimately leading to productive and real economic activities. The financing is based on the productivity of the venture.
- **Conventional Banking**: Conventional bank transactions are not backed by real assets. The credit extension is based on creditworthiness or financial history.

**iv. Prohibition of Speculation/Uncertainty (Gharar)/ and Unlawful investments:**

- **Islamic Banking**: Islamic banking prohibits speculative, uncertain transactions (Gharar). And investment in lawful activities. Contracts and transactions must be clear and transparent.

- **Conventional Banking**: Conventional banking is profit-oriented, and their transactions are not guided by any ethical and moral principles. They do not have any restrictions on investment in speculation, gambling or unlawful activities.

**v. Role of Sharia Supervision**:

- **Islamic Banking**: Islamic banks have a Shariah advisory committee which develops Islamic banking products and examines the compliance of activities with Shariah law.
- **Conventional Banking**: Conventional banks do not have any framework for the compliance of illegal or unethical transactions and religious oversight structures.

**vi. Philosophy of Social Responsibility**:

- **Islamic Banking**: Islamic banking often emphasizes social and ethical responsibility, including the collection and distribution of Zakat funds to support the less fortunate in the community.
- **Traditional Banking**: Conventional banks may engage in corporate social responsibility but are not tied to specific religious obligations.

**vii. Basis of Profit**

- **Islamic Banking**: Islamic banking profits are earned through goods and services and depend on real economic activity.
- **Conventional Banking**: Conventional banks charge interest on capital and the interest depends upon the time value of money.

**viii. Growth of society**

- **Islamic Banking**: Islamic banking promotes economic activity, and the real wealth of the people is growing due to the circulation of money through the different classes of society.
- **Conventional Banking**: In conventional banking, the real growth of wealth does not take place as money remains in the hands of a few people.

**Table 2.1: Difference between Islamic and Conventional Banking**

| Aspect | Islamic Banking | Conventional Banking |
|---|---|---|
| Interest based transactions | Refrains from interest-based transactions, | Based on interest-based transactions; mobilizes interest deposits; charges interest on loans. |
| Risk and Reward Sharing | Shares risk and rewards between partners; focuses on profit-and-loss sharing. | Charges fixed interest rate: transfers risk to other party. |
| Asset-Backed Financing | Financing backed by tangible assets; based on the productivity of the venture. | Transactions not backed by real assets; based on creditworthiness. |
| Prohibition of Speculation/Uncertainty | Prohibits speculative, uncertain transactions; invests in lawful activities. | Not guided by ethical principles; no restriction on speculation or unlawful activities. |
| Role of Sharia Supervision | Supervised by Shariah advisory committee; ensures compliance with Shariah law. | No framework for compliance with ethical or religious principles. |
| Philosophy of Social Responsibility | Emphasizes social and ethical responsibility; supports distribution of Zakat funds. | May engage in corporate social responsibility; not tied to religious obligations. |
| Basis of Profit | Earns profits through goods and services; depends on real economic activity. | Charges interest on capital; depends on the time value of money. |
| Growth of society | Promotes economic activity; circulates money through different classes of society. | Real growth of wealth does not occur; money remains concentrated. |

## SUMMARY

In this unit, we explored the essential concepts in Islamic finance and banking. We began by defining terms such as Shariah, Aqeedah, Fiqh and Akhlaq, laying the groundwork for understanding Islamic economic principles. We then examined the sources of Shariah law, including Ijma, and Qiyas, which serve as the basis for deriving Islamic legal rulings. This unit also addressed the concept of Riba, its prohibition in the Quran and Hadith, and its significance in Islamic finance. Furthermore, we discussed the framework and principles of Islamic banking, emphasizing its focus on ethical and equitable financial practices. Finally, we compared Islamic banking with traditional banking systems, identifying major differences that distinguish the two approaches. Overall, this unit provided a comprehensive overview of key concepts and principles in Islamic finance and banking.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
    i. What are the sources of Shariah?
    ii. List down sources of Shariah.
    iii. What is Ribah and its classification?
    iv. Define Muamalat (man-to-man activities).
    v. What is the Islamic Banking framework?

2. Write long notes on the following questions.
    i. Explain in detail the prohibition of Ribah in the Quran and Sunnah and the rationale behind its prohibition.
    ii. Islamic Banking Principles
    iii. The difference between Islamic and conventional banking.

3. Please fill in the blank spaces.
    i. ……provides the ethical and moral guidelines within which behaviour, attitudes and conduct of the Muslims can be determined.
    ii. Preservation of ……is concerned with safeguarding the lives and well-being of individuals, promoting health, and safety, and preventing harm to the lives of the individuals.
    iii. ……. literally means Gambling or a game of chance and denotes acquiring wealth such that it deprives others of its rights.
    iv. Shariah an Arabic word (شريعة) means…….
    v. ……. means judging by comparing with something.

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**Unit–3**

# SOURCES OF FUNDS IN ISLAMIC BANKS

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## INTRODUCTION

This unit examines the essential components of Islamic banking, focusing primarily on the sources of funds and major modes of profit and loss sharing used by Islamic banks. Understanding the sources of funds and the fundamental product of Islamic banking is crucial for comprehending the unique operational mechanisms within this financial framework. This unit begins by examining the various sources of funds used by Islamic banks which include deposits and shareholders' funds. Subsequently, it explores the significant modes offered by Islamic banks, highlighting Mudarabah and Musharakah as central pillars of Islamic finance. Furthermore, it explores the details of Mudarabah and its implications for deposit management, offering valuable insights into the practical applications of Islamic financial principles.

## OBJECTIVES

At the end of this chapter, you will be able to.

i. Understand the sources of funds available to Islamic banks, including deposits maintained by these institutions and shareholders' funds.

ii. Analyze the characteristics and functionalities of different types of accounts held by Islamic banks, such as current accounts, savings accounts, and investment accounts.

iii. Explore the major products offered by Islamic banks, particularly focusing on Mudarabah and Musharakah as main profit and loss sharing modes.

iv. Understand the operational dynamics of Mudarabah and its significance in deposit management within Islamic banking.

## 3.1 Sources of Funds for Islamic Banks

Islamic banks meet borrowers' financial needs by mobilizing investors' savings. Their funding sources include deposits in various accounts, special investment accounts for corporate project funding, and shareholder funds. These funds are then channelled to support general financing, trade financing (working capital, domestic and international trade), country treasury products (Islamic money market instruments), and other services.

An Islamic bank shares in the profit and loss of each borrower's business transaction. The bank then distributes its share of profits and losses to its general and special investors who have deposited funds. Profit is calculated ex-post, based on the outcome of the borrowers' business transactions. Before sharing profits with shareholders as dividends, the bank deducts operating expenses, zakat (the Islamic welfare tax), and government taxes.

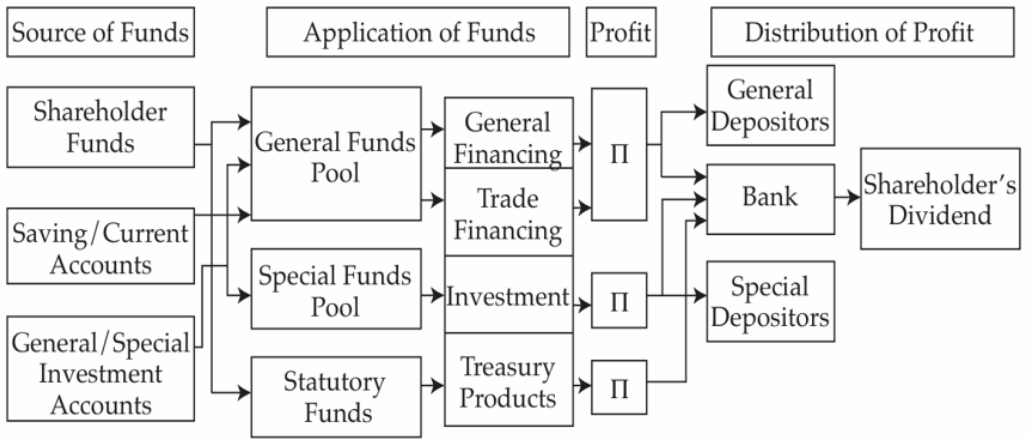



**Figure 3.1: Overview of profit mechanism in Islamic banking**
**Source: Islamic Banks are on the rise (2008)**

### 3.1.1 Deposits Maintained by Islamic Banks

Like conventional bank depositors, Islamic banking depositors seek safe custody of their funds and convenient access. They may also expect to earn a profit on their deposits, though this is not guaranteed. Islamic bank's sources of funds include shareholder investments, savings accounts, current accounts, and investment accounts (general and special).

#### (a) Saving Accounts

Islamic banks follow the principle of Wadiah in managing customer savings accounts. With the customer's permission, the bank can use the deposited funds while maintaining full discretion over them. Although the bank does not share the

profits earned from these funds with the customer, it guarantees the deposits. As a token of appreciation, the bank may offer a hibah (gift), which can be a portion of the profit generated from the use of the funds. Hibah may be paid by the bank at any time. However, is typically paid at regular intervals, such as quarterly or semiannually.

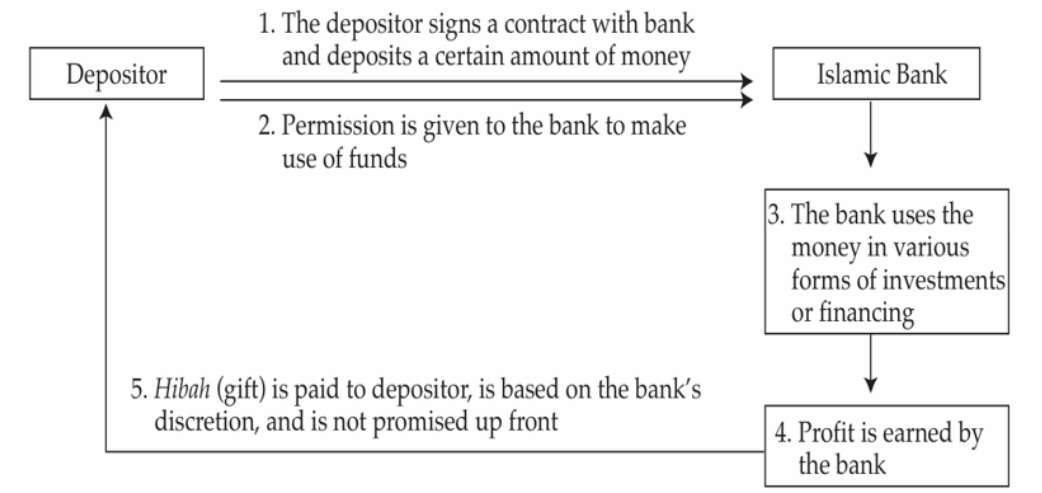



**Figure 3.2: Structure of Wadiah Savings Account**
**Source: Book: A Primer on Islamic Finance**

**(b) Current Accounts**

A current account is a deposit account for business or personal use, providing safe custody of deposits and convenience for customers. Like savings accounts, current accounts operate under the Islamic principle of Wadiah. Deposit holders are not guaranteed a return on their deposits but may receive a Hibah (gift). The balances in current accounts are guaranteed. Unlike savings accounts, current accounts offer more flexibility with minimum balance limits and withdrawals.

In some countries, such as Iran, the use of current account deposits is governed by the principle of Qard Hassan (benevolent loan or interest-free loan). Deposits are treated as loans from the depositor to the bank, allowing the bank to use the funds without the depositor's permission. The depositor, acting as a lender, does not receive any return on the funds, thereby avoiding Riba (interest).

**(c) Investment Accounts**

Investment accounts, also called profit-sharing investment accounts (PSIA), operate on the principle of Mudharabah where profits and losses are shared between Islamic banks and depositors. In this arrangement, depositors act as silent partners (Rabb ul-mal), while the bank manages the funds as an agent (Mudarib). The bank

invests in Shari'ah-compliant stocks and projects. Although termed profit-and-loss sharing accounts, any investment losses are borne by the investor unless caused by the bank's misconduct or negligence. Islamic banks typically do not charge management fees; instead, returns come from shared profits. These accounts are crucial for funding the banks' investment and financing activities.

An investment account can be classified into two types:

i. **General Investment Account/Unrestricted PSIA**:
The investor allows the bank to invest the funds in any Shari'ah-compliant manner without any restrictions.

ii. **Special Investment Account/Restricted PSIA**:
The investor sets specific conditions, restrictions, or preferences on how and where the funds should be invested. The bank must adhere to these guidelines while ensuring Shari'ah compliance.

**Table 3.1: Sources of Funds in Islamic Banking**

| Account Type | Objective | Principal Value Guaranteed? | Profit-Sharing Method | Risk |
|---|---|---|---|---|
| *Wadiah* savings account | Precaution and to earn a profit | Yes | *Hibah* at bank's discretion | None |
| *Wadiah* current account | To have liquidity available on demand | Yes | Generally no profit sharing | None |
| *Qard hassan* current account | To have liquidity available on demand | Yes | Generally no profit sharing | None |
| General investment account | To earn a profit | No | Profit sharing at negotiated ratio | High |
| Special investment account | To earn a profit | No | Profit sharing at negotiated ratio | High |

**Source: Bjorklund and Lundstrom (2004)**

### 3.1.2 Shareholders' Funds

Apart from the Shariah-based deposits, Islamic banks also raise a sizeable portion of their funds by issuing shares (equity participation). Equity financing in Islamic banks is based on the principle of Musharakah. According to equity participation mode Musharakah, investors when purchasing the shares of the banks enter into a partnership agreement with the bank. Islamic banks may contribute their capital to the capital provided by the shareholders to make an equity pool which is further

invested in shariah-based instruments. Profit and losses are shared according to the share of the investment.

**Table 3.2: Islamic Banking Deposits (Liabilities side of balance sheet)**

| Assets | Liabilities |
|---|---|
| Cash and Liquid Securities | Demand deposits |
| Inventory (Real Estate, Automobiles, Commodities etc) | Savings deposits |
| Financing and Asset-backed transactions.<br>Murabahah, Salam, Istisna, Ijara | Restricted profit-sharing Investment accounts |
| PLS Transactions (Mudarabah, Musharakah) | Unrestricted profit-sharing Investment accounts |
| | Reserves (PER, IRR) |
| | Shareholders equity capital |

## 3.2 Proft and Loss Sharing Modes Used for Savings Mobilization

Islamic banks use Mudrabah and Musharakah to mobilize the savings of the investors. The details of both these modes are as follows:

### 3.2.1 Mudarabah

#### (a) Mudarabah Contract

Mudarabah comes from the Arabic root word Dhabarh Fil Ard which means going and working to earn a livelihood. Mudarabah is a type of profit and loss sharing mode based on Islamic principles in which one party called the Rabbul Maal provides the capital to transact the business to the other party called the Mudarib. Rabbul Maal participates with capital and Mudarib participates by contributing necessary experience and management expertise. Both parties enter into the contract to undertake a joint venture to share the profits of the business according to the terms agreed at the time of the contract. Mudarabah business is in line with the Islamic principles of risk sharing and profit sharing.

#### (b) Profit and Loss of the Mudarabah Business

Profit sharing is the primary motive of the Mudarabah contract. However, the profit and loss is distributed among both the parties subject to the following conditions;

- It is necessary for the validity of the Mudarabah contract that the profit-sharing ratio should be agreed between both parties right at the inception of the contract. Shariah has not prescribed any proportion rather it has been left solely to the discretion of the contracting parties that they should determine by mutual consent.

- Whereas the loss, if any, is borne by the capital provider if the loss is not due to negligence or misconduct of the Mudarib. In case of loss, the capital provider suffers the loss in capital to the extent of the loss whereas the loss to the Mudarib is to the extent that his efforts and labour goes in vain. If loss occurs because of a misuse or a violation of the conditions of the contract on the part of Mudarib, then he alone is liable to recover it.

**(c) Process of Mudarabah**

The process of Mudarabah is diagrammatically explained as follows.

i. Investors provide capital to the Mudarib to start a venture.
ii. Mudarib contributes only to management expertise.
iii. Mudarib is responsible for the day-to-day expenses and deducts only operating costs from the revenue. The remaining is distributed between both.
iv. Loss is borne by Rabbul mal only.

**(d) Types of Mudarabah**

There are two types of Mudarabah contracts which are as follows.

i. **Restricted Mudaraba (Mudarabah Al Muqayyadah)**
   It is a type of Mudaraba contract in which the provider of the capital may impose certain restrictions at the time of the contract. Rabbul Mal may restrict Mudarib to use the capital provided by him by mentioning the type of commodity to deal in, the period of the contract, the place of business, and also mention the counterparties with whom the Mudarib will transact the business.

ii. **Unrestricted Mudaraba (Al Mudarabah Al Mutlaqah)**
   In unrestricted Mudarabah, Mudarib is at full liberty to transact whatever activity he deems fit. Mudarib can trade in any commodity, with any person at any place provided it is in compliance with Islamic principles. He is authorized to do anything done in a normal course of business. However, any extraordinary work not being done in the normal course of the business requires the permission of the Rabbul Mal. Furthermore, Mudarib is not authorized to keep another partner and mix his investment into Mudarabah without the consent of Rabbul Mal.

**(e) Use of Mudarabah**

Mudarabah helps finance productive avenues and helps promote cooperation and trust among the partners. Mudarib who is entrusted with the Mudarabh funds may be a natural person, a group of persons, a legal entity, a financial institution or a corporate body. Mudarib acts as trustee and should work with full integrity to invest the entrusted funds in productive businesses such as

i. General or specific investment,
ii. Project financing/ Bridge financing,

iii. Working capital and SME financing,
iv. Inter-bank investment
v. Banks deposit management.

Mudarabah is the best mode to utilize the idle savings of the people and help finance Shariah-based products. It promotes equality and justice in society when the people are rewarded according to their efforts. Thus, the need is to let the people understand the importance of Islamic finance and the role it plays in the stabilization of the economy.

**(f) Shariah legitimacy of Mudarabah**

The legitimacy of the Mudarabah contract established based on the shariah sources is as follows.

**i. Holy Quran**

ALLAH S.W.T. has made all trade ventures including Mudaraba permissible provided they are according to the Shariah principles. The Holy Quran indicates the permissibility of Mudaraba in the following verses.

*"…others travelling through the land, in the quest of ALLAH's bounty…" Surah Al-Muzammil (73: 20)*

*"When the prayer ends, disperse through the land and seek the favour of ALLAH. Remember him often so that perhaps you will have everlasting happiness (in this world and hereafter)." Surah Al-Jumu`ah (62: 10)*

These verses do not directly refer to Mudarabah but attempt to make Mudarabah permissible by referring to travel for conducting business to earn legitimate income both for the benefit of the masses themselves and for the public interest. Both these verses imply that Muslims seek Allah's bounty by earning in the manner prescribed by Allah S.W.T.

**ii. The Sunnah of The Prophet Muhammad (S.A.W.)** حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ

Mudarabah was also being practised at the times of Prophet Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ and he practised Mudarabah when he used to travel to Syam to trade with other people's money including that of Hazrat Khadijah Binti Khuwailid (R.A). The following Hadiths explain the permissibility of the Mudarabah by Prophet S.A.W. حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ.

The Narration of Ibn Abbas:
Ibnu Abbas R.A. reported that: "When our leader Abbas Ibn Abd al-Mutallib gives his property to someone for Mudarabah, he stipulated conditions for his partner not to bring the capital throughout the sea; and not to bring with him the capital crossing a valley, and not to buy livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These conditions have been brought to the attention of Prophet Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ and he approved them." (Al-Tabrani).

The Narration of Soleh bin Suhaib:
*"Reported by Soleh bin Suhaib from his father, he said: Rasulullah S.A.W.* حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ *once said: There are three blessed things; deferred sale, Muqaradah and mixing barley and wheat (for household consumption) and not for sale." (Sunan Ibn Majah).*

Both the terms Muqaradah and Mudarabah are synonymous and can be used interchangeably.

iii. **Ijma**

Muslim scholars have conducted Ijtihad on the permissibility of the Mudarabah contract and reached ijma amongst them. It has been established that companions of Prophet Muhammad S.A.W. حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ such as Hazrat Umar, Hazrat Usman, Hazrat Ali, Hazrat Abdullah Ibn Mas`ud, Hazrat Abdullah Ibn Umar, Hazrat Ubaydullah Ibn Umar R.A. invested the property of orphans under Mudarabah contract there was no contradictory view among other companions and is termed as Ijma.

**(g) Termination of Mudarabah**

Mudarabah can be terminated under certain conditions which are as follows:

- By mutual consent between the parties to terminate the contract.
- With the completion of the venture for which it was undertaken.
- With the expiry of the period for which it was created.
- With the death of either party.
- When the Mudarabah funds are insufficient to continue the venture.
- When there exists any of the conditions that render the contract invalid. In this case, Mudarib acts as and employee and gets customary remuneration.

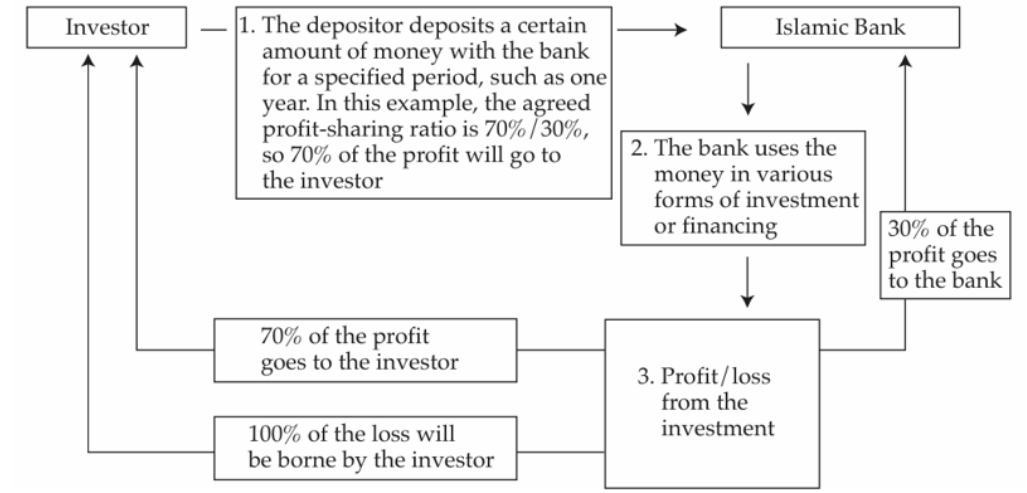



**Figure 3.3: Structure of Mudarabah-based financial products**
**Source: Book: A Primer on Islamic Finance**

### 3.2.2 Musharakah

#### (a) Meaning of Musharakah

Musharakah involves two or more individuals collaborating in a business, each contributing a specific amount of capital according to a contract. They jointly manage the business and share profits and losses based on an agreed-upon proportion. In Musharakah, a bank acts as the partner with the depositors and profits are shared in a predetermined ratio. However, losses are sustained by the partners in proportion to their capital contribution.

#### (b) Musharakah Contract

Musharakah is an equity-based product. The rules of the Mudarabah contract are;

i. It may have a combination of a sleeping partner and a working partner.
ii. Musharkah contract with the mutual consent of all the partners can employ a new partner.
iii. At the time of sale, every partner is required to the share of another partner at market Price, or an agreed price.
iv. If the capital is not in the form of money but a commodity, its market value will be ascertained at the time of contract.
v. Capital must be specified and existing.

#### (c) Profit and Loss of the Musharakah Contract

- Profit can be distributed among the partners according to the mutually agreed ratio.
- The share of profit may differ from the ratio of capital or investment provided it is mutually agreed upon.

- The percentage of profit of a sleeping partner cannot exceed the share of his investment.
- Losses must be shared according to the percentage of the investment.
- If the loss occurred due to the negligence of a partner, only that partner will be responsible for the loss, not other partners.
- The agreed percentage is the percentage of profit, not the capital.
- Partners cannot give any guarantee for the payment of profit or capital.

**(d) Type of Shirkah**

***Shirkat-ul-Milk***

This type of shirkat is based on the joint ownership of two or more partners in a particular business/venture/property. Shirkat-ul-Milk may be established among the partners due to inheritance. Every partner has a right to use, sell, lease or gift to the extent of his ownership. Similarly, the profit and losses are shared according to the percentage of ownership.

***Shikrat-ul-Aqd***

It is the type of partnership that comes into existence because of a mutual contract. It is also known as a joint commercial enterprise/partnership. It is further divided into three types.

i. Shirkat-ul-Amwal is a type of partnership in which all the partners contribute some capital to the commercial venture.

ii. Shirkat-ul-A'mal is a type of partnership in which all the partners jointly undertake to render some services to the client. The fee charges are distributed among the partners according to the agreed ratio.

iii. Shirkat-ul-wujooh is a type of partnership that requires no monetary investments. It is a partnership based on the creditworthiness of the partners. They purchase goods on credit and sell them on cash. The profit earned is shared according to the agreed ratio.

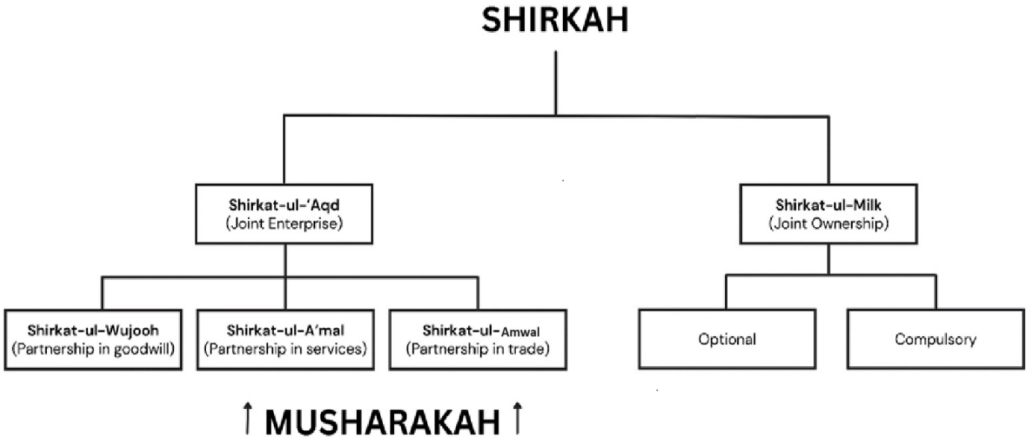



**Figure 3.4: Types of Shirkah**
**Source: Introduction to Islamic finance, Mufti Taqi Usmani**

In Islamic Fiqh, all forms of sharing or partnership are referred to as "shirkah." The term "musharakah" does not appear in classical Fiqh texts; it was recently introduced by scholars discussing Islamic financing methods. "Musharakah" usually refers specifically to "Shirkat-ul-amwal," where two or more individuals invest capital in a joint commercial venture. Occasionally, it also includes "Shirkat-ul-a'mal," where the partnership involves providing services. So, Musharakah, or Shirkat-ul-amwal, is a partnership formed through a mutual contract between parties. Consequently, all essential elements of a valid contract must be present in this arrangement.

**(e) Shariah Legitimacy of Mushakarah**

The following Hadith of Prophet Muhammad (Peace Be Upon Him) highlights the importance of partners.

*"Allah says. I am the third of the two partners, as long as they do not cheat one another. But, when one of them cheats the other, I leave them".* (Sunan Abu Daud).

**(f) Termination of Mushakarah**

Any partner can leave the Musharakah partnership at any time by giving notice to all the partners. If a partner dies or becomes insane or incapable of working as a partner the partnership contract is ended.

## 3.3 Mudarabah & Deposit Management

Islamic banks transfer the funds received from the depositors to a pool of the funds and the pool is used by the bank to finance the customers using Shariah complaint financing modes such as Murabahah, Ijara, Diminishing Musharaka, Salam and Istisna. Deposits are joined together in a pool and depositors are allocated a weight which accounts for the deposit amount and the tenure which the deposit is kept for. The weightage is being done transparently at the beginning of each month. Profit is shared between both the depositors and the bank according to an agreed ratio. In case of loss, it is borne by depositors while the bank gets nothing.

### 3.3.1 Types of Investment Pools

Following are the four main types of investment pools maintained by Islamic banks.

**i. Deposit Pool**

Deposit pool comprises of the funds mobilized through remunerative deposits such as savings and Investment accounts.

**ii. Equity Pool**

The equity pool is comprised of the funds from the current accounts and the bank's equity. These funds are invested in permissible equities and Islamic instruments.

**iii. Special Customer Pool**

A special customer pool comprises of funds received from the customer under some special arrangements such as Musharakah and restricted Mudarabah.

**iv. Financial Institutions pool**

Financial institution pools are special-purpose pools maintained to meet the short-term liquidity requirements of Islamic banks.

### 3.3.2 Distribution of Profit and Losses in Deposits of Islamic Banks

Consider the distribution of profit and loss between the bank and depositors by hypothetical example;

**A) Creation of an Investment Pool:**

1. First, an investment pool is created.
2. The pool is invested in Shariah compliant products by the bank.
   Suppose there are three deposits of varying period.
   i. Three months ii. Six months iii. One year

   Based on the above tenure the pool will have three categories:
3. Let's suppose customers deposit funds in each of the three categories as follows:

| | |
|---|---|
| Three months | 4,000 |
| Six months | 3,500 |
| One year | 2,500 |

4. Weights are assigned to each investment category based on the tenure. Weights are assigned as follows;

| | |
|---|---|
| Three months | 0.6 |
| Six months | 0.7 |
| One year | 1.0 |

   The accounting period is one year therefore the category of tenure one year has been assigned the weight one. All the depositors in the pool are partners with the above-mentioned profit-sharing weightage.

5. The following is the pool created based on investment and weightage.

| Tenure | Deposit Rs. | Weightage |
|---|---|---|
| Three months | 4,000 | 0.6 |
| Six months | 3,500 | 0.7 |
| One year | 2,500 | 1.0 |
| Total | 10,000 | |

**B) Pool relationship with the bank**

The bank enters into a Mudarabah contract with a pool; depositors are the Rabbul Mal and the bank Mudarib. The bank invests the funds, and the resultant profit is shared in the agreed ratio.

**C) Profit sharing between the bank and the pool:**

The amount raised by the investment pool is invested by the banks in Shariah compliant products, and the profit is shared in an agreed ratio. Suppose the bank invests the amount of 10,000 for one year and earns a profit of 1,000 at the end of the year. The profit is shared between them on a 50:50 basis.

| | |
|---|---|
| Bank | 500 |
| Pool | 500 |

**D) Profit sharing amongst the depositors:**

The profit is shared within the pool on the basis of the weightage assigned to each category at the beginning of the month.

| Tenure | Deposit | Weightage | Weighted Average | Profit* | Rate** |
|---|---|---|---|---|---|
| | A | B | A*B = C | D | |
| Three months | 4,000 | 0.6 | 2,400 | 163 | 4.08% |
| Six months | 3,500 | 0.7 | 2,450 | 167 | 4.76% |
| One year | 2,500 | 1.0 | 2,500 | 170 | 6.80% |
| Total | 10,000 | | 7,350 | 500 | |

***Profit = C/7350* 500**

****Rate = D/A *100**

**E) Loss sharing between the bank and the pool**

According to the Mudarabah contract, losses are borne by the pool as Rabbul Mal. In such cases, the bank gets nothing and makes a loss due to non-recovery of expenses incurred in the business.

**F) Sharing of loss among the depositors**

Loss attributable to the depositors is shared among the pool members according to their investment ratio.

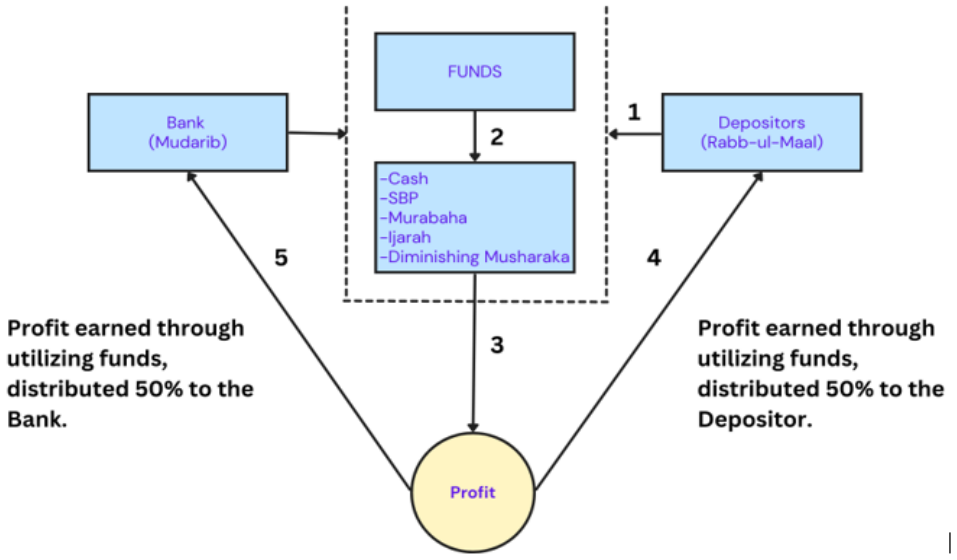



**Figure 3.5: Process of Mudarabah between Depositors and Islamic Bank**
**Source: Google**




**Figure 3.6: Profit Computation and Distribution Process Flow**
**Source: SBP Circular: Instructions for Profit & Loss Distribution and Pool Management for Islamic Banking Institutions (IBIs)**

## SUMMARY

This unit provides details about the foundational aspects of Islamic banking, emphasizing om the sources of funds accessible to Islamic banks and the major products they offer. It begins by discussing the various types of deposits maintained by Islamic banks, including current accounts, savings accounts, and investment accounts, highlighting their significance in the overall funding structure of these institutions. Additionally, the unit examines the role of shareholders' funds in Islamic banking, explaining their contributions to the financial stability and growth of these banks. Furthermore, the unit explores the major products offered by Islamic banks, with a particular focus on Mudarabah and Musharakah. It provides a comprehensive analysis of Mudarabah, outlining its principles, functionalities, and implications for deposit management within the context of Islamic finance. By examining the operational dynamics of Mudarabah, the unit offers valuable insights into the practical applications of Islamic financial principles in managing deposits and facilitating investment activities within Islamic banking institutions.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
   - vi. What is a current account?
   - vii. What is Amanah?
   - viii. Define the profit-sharing investment accounts?
   - ix. Name the major products used by Islamic banks as profit & loss Sharing modes?
   - x. Name the types of deposits maintained by Islamic banks?

2. Write long notes on the following questions.
   - iv. Write the detailed note on Mudrabah contract?
   - v. Write the detailed note on Musharakah contract?
   - vi. How Mudarabah is applied in deposit management?

3. Please fill in the blank spaces.
   - i. Mudarabah comes from Arabic root word Dhabarh Fil Ard which means…….
   - ii. In Mudarabah, Rabbul Maal participates with …….and Mudarib participates with…….
   - iii. …… is based on joint ownership of two or more partners in particular business/venture/property.
   - iv. ……. are the non-remunerative accounts maintained for the safe custody of deposits and for the convenience of customers.
   - v. The profit-sharing investment accounts are also known as ……. accounts

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Islamic economics video lectures; Dr. Muhammad Abubakar Siddique

**Unit–4**

# ISLAMIC MODES OF FINANCING

**Written by: Dr. Nosheen**

**Reviewed by: Dr. Muhammad Suleman Afzal**

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## INTRODUCTION

Islamic finance stands apart with its principles deeply rooted in Shariah law, offering a unique framework for financial transactions guided by ethical and religious principles. In this unit, we delve into the various modes of financing within Islamic banks, highlighting the trade/sale-based modes, lease-based modes, and profit and loss sharing modes. Through an exploration of these modes, we aim to provide a comprehensive understanding of how Islamic banking financing modes operate within the framework of Shariah principles.

## OBJECTIVES

At the end of this unit, you will be able to

i. Understand the principles underlying Islamic banking and finance.

ii. Explore the different trade/sale-based modes employed in Islamic banking, including Murabahah, Salam, and Istisna.

iii. Analyze the lease-based mode of financing, specifically Ijara, and its application within Islamic banking.

iv. Examine the profit and loss sharing modes, namely Mudarabah, Musharakah, and Diminishing Musharakah, and their application as the financing instrument on the asset side of Islamic banks' balance sheet.

## 4.1 Financing in Islamic Banks

Financing activities are the activities in which Islamic banks meet the financing needs of different types of the customers. Islamic banks use different instruments to meet the different needs of the customers. Financing activities of Islamic banks are based on Shariah principles and are different from conventional banks.

### 4.1.1 Financing Instruments in Islamic Banks

Financing activities in Islamic banks are based on three types of modes/instruments.

i. Trade/Sale Based Modes
ii. Lease-Based Modes
iii. Profit and Loss Sharing Modes.

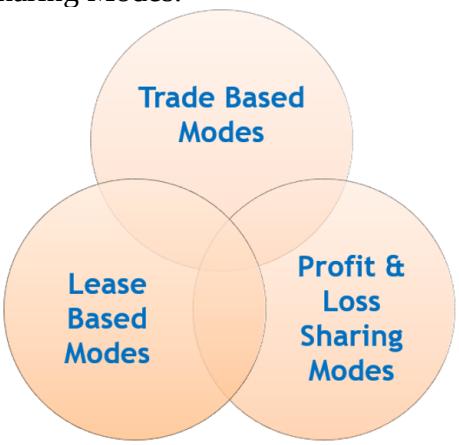



**Figure 4.1: Modes of Financing in Islamic Banking**
**Source: Self-Created**

## 4.2 Trade/Sale Based Modes

Sale-based modes are divided into two types.

**i. General Sale**
A general sale is a type of sale in which the seller quotes the selling price without disclosing the cost price to the buyer.

**ii. Trust Sale**
Trust sale is a type of sale in which the seller quotes the selling price by disclosing the cost price to the buyer. There are three types of trust sales.

**a. Bay Tawliyah: Cost to cost sale**
This form of sale entails setting the selling price equivalent to the initial purchase cost (cost of acquisition). For example, in a Tawliyah transaction, an asset purchased for $2,000 historically may be sold for the same price of $2,000 presently, with no markup added to its original cost.".

**b. Bay Wadia: Below the cost of sale**
Wadîah denotes the sale of an item at a price lower than its original cost.

**c. Bay Murahabah: Cost plus profit sale.**

It involves selling a product for a price that includes its initial cost along with a designated markup, either as a percentage or a fixed amount. During this transaction, the seller must disclose the actual cost of the product to the buyer, and both parties must agree on the markup.

### 4.2.1 Preliminary: Rules Applicable for Islamic Sale

Shariah has provided certain rules regarding the applicability of the sale according to the Islamic principles which are as follows.

i. Subject matter (good to be sold) must be existent at the time of sale.
ii. Subject matter must be in ownership of the seller.
iii. Subject matter should be in the physical or constructive possession of the seller.
iv. Subject matter must be property of value
v. Subject matter should be *Halal*
vi. The mode of delivery and the price of the subject matter should be certain.
vii. Subject matter must be known and identifiable.
viii. Sale must be instant and absolute.

### 4.2.2 Murabahah

**(a) What is Murabahah?**

Murabahah is a Shariah-based financing mode used by Islamic banks in which the bank sells the commodity to its customer by disclosing the purchase price and the agreed profit. Profit may be a percentage of the selling price or a lump sum. Murabaha is a cost-plus financing arrangement under which the bank, upon the request of the client, first purchases the asset from the third party (supplier/vendor) and sells it to the customer either against immediate payment or based on deferred payment mutually agreed upon. The seller is required to disclose the cost and the profit to the buyer.

**(b) Uses of Murabahah:**

Murabah is used in various transactions that are based on cost plus sale and comply with the shariah principles e.g.,

i. Short/Medium/Long Term Finance for raw material, Inventory, and Equipment.
ii. Asset financing
iii. Import financing.
iv. Export financing.
v. Consumer goods financing, House financing, Vehicle financing, land financing

**(c) Shariah Legitimacy of Murabahah**

Shariah legitimacy of the Murabahah contract is deducted from the following verses of the Holy Quran.

*"It is no crime for you to seek the bounty of your Lord"*
*Surah Ale Imran (3:198)*
*"Allah has permitted trade"*
*Surah Al-Baqarah (2:275)*

Following the hadith of Prophet Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ also provides precedence for the shariah legitimacy of the Murabaha contract.

> *"The Prophet (PBUH)* حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ *purchased the camel from Abu Bakr (RAA) for use as transportation from Madinah at the time of migration and the Prophet (PBUH) accepted this offer at cost". Sahih Bukhari (Kitab ul Libass Hadith No. 5807)*

**(d) Stages of Murabah Contract**

i. **Pre-Promise Stage – Facility Approval**

At the pre-promise stage, the bank, before the facility approval undertakes a preliminary investigation and ensures that the nature of the commodities required by the client are within the scope of the valid Murabahah contract.

ii. **Promise Stage – Master Murabaha Facility Agreement**

At the promised stage the customer and the bank sign an agreement known as Master Murabaha Facility Agreement to legally enter into the Murabahah contract. Under such an agreement, the bank promises to sell the commodity and the client promises to purchase the commodity at an agreed ratio of profit added to the cost.

The Master Murabaha facility agreement, or MoU, specifies the terms and conditions of the contract the includes.

a. the limit of the Murabahah facility,
b. the nature of the Murabahah commodity,
c. the agreed profit margin to be taken by the bank,
d. the schedule of payment,
e. the security deposit to be submitted by the customer (Hamish Jiddiya).
f. specimens of purchase requisition.

iii. **Purchase Requisition**

After MMFA, a purchase requisition, undertaking and security deposit are provided by the client to the bank.

i. The purchase requisition is submitted by the client to the bank instructing the bank to purchase the commodity according to the specifications. The requisition will include details regarding.
    a. the commodities purchased
    b. the name of the supplier
    c. the cost price
    d. expected date of the delivery.
ii. The undertaking is given by the client that he will buy the commodities which the bank will purchase on his request. Undertaking is the promise to acquire the goods.

iii. The security deposit or the earnest money (Hamish Jiddiyah) is provided by the client to the bank to assess the client's sincerity in purchasing the commodities.

iv. **Agency Stage**
In the agency stage, an agency agreement is executed in which the bank either appoints the client to purchase the goods on behalf of the bank or the third party can be appointed by the bank as an agent to purchase the commodity.

v. **Purchasing Stage**
The client or the third party purchases the commodity on behalf of the bank and takes possession as the agent of the institution. The client or the third party informs the bank that it has purchased the commodity. When the client himself purchases the commodity on behalf of the bank simultaneously places an offer to purchase the commodity as well.

vi. **Acquisition of Title and Possession of the Asset**
After goods are purchased by the agent they are transferred to the ownership and the possession of the bank. Payment is made to the supplier and the discount by the supplier, if any, is given directly to the client. The title of the good lies with the bank and the possession may be physical or constructive. At this stage the rights and responsibility of the commodities lie solely with the bank.

vii. **Execution of Murabaha Stage – Offer and Acceptance**
The customer at this stage, if he has purchased commodities himself on behalf of the bank, provides a possession report to the bank. At this stage, the client makes an offer to purchase the commodity acquired by him. The bank accepts the offer and the Murabahah sale is executed. The bank provides a letter of acceptance to the client stating the contract price (cost plus profit), due date or schedule of payments. Once goods are delivered to the client (in the case of third-party agents) the relationship between the bank and the client changes from buyer and seller to debtor and creditor. Once ownership is transferred to the client the bank is no longer responsible for any loss to the goods and the risk and responsibility of the goods transfers to the client.

viii. **Security/Collateral against Murabaha Price**
The client at this stage pays the agreed price to the bank, the collateral is released by the bank and the Murabahah contract is terminated.

**(e) Shariah Ruling of Murabahah**

For completion of Murabahah sale transactions, the following guidelines have been laid down by Shariah which include.

**i. Identifiable and specific commodities**
Goods sold under the Mubarahah contract should be identifiable and specifically known to the buyer.

**ii. Ownership and Possession of goods**
Goods sold under the Murababah contract should be under the ownership and possession of the bank at the time of the sale. Possession can be physical or constructive. Constructive possession means that goods are under the ownership of the bank but not physical possession. The rights and responsibilities of the goods lie with the bank which is the seller of the goods.

**iii. Price confirmation**

The price of the goods under the Murabahah contract is agreed upon at the time of the sale, the price cannot be changed once the sale contract is executed,

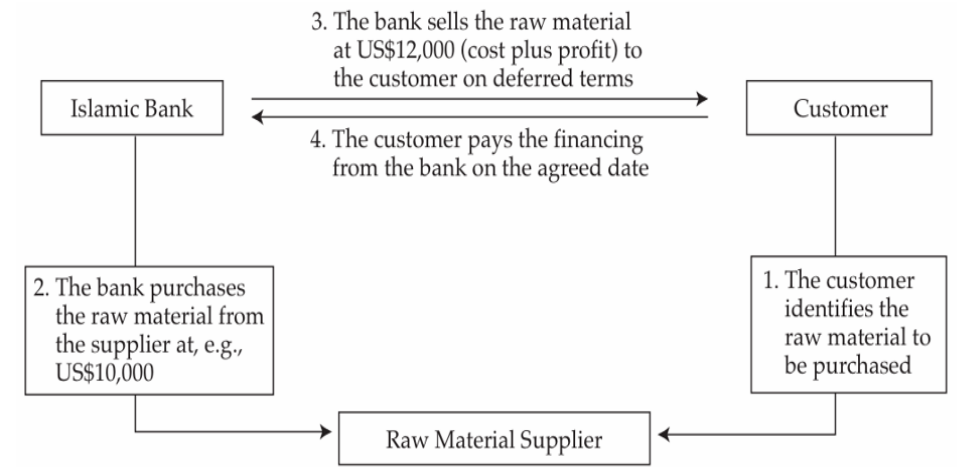



**Figure 4.2: Structure of Murababh Financing**
**Source: Book: A Primer on Islamic Finance**

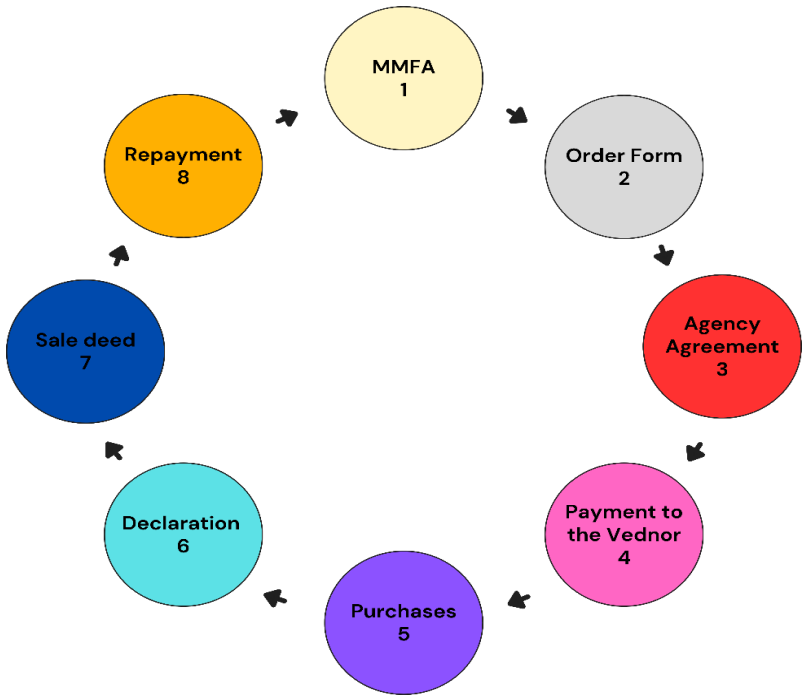



**Figure 4.3: Stages of Murabahah Contract**
**Source: Self-created**

### 4.2.3 Salam

**(a) What is Salam?**

Salam represents an alternative sales arrangement wherein a specific commodity is agreed upon for transaction even before its actual existence. Salam is the financing instrument used by Islamic banks to finance and facilitate agriculture transactions and small traders. It is a forward contract between the bank and the client in which the bank agrees to deliver the specified goods to the client (buyer) at some predetermined delivery date in the future against the full payment made by the client on spot.

**(b) Uses of Salam**

Salam financing is mainly used by financial institutions to finance the agriculture sector. Salam contract is designed to meet the needs of funds by the farmers to buy seeds and other inputs for cultivation. It is also used for.

i. Purchase of commodities (Agriculture/ Minerals)
ii. Export financing
iii. Industrial financing
iv. Liquidity requirements/ Working capital financing.

**(c) Shariah Legitimacy of Salam**

Allah says in the Quran;

> *"O you who believe when you deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing"*
> *Al-Baqarah (2:282)*

A Hadith is narrated on the authority of 'Ibn 'Abbas, when the Prophet (PBUH) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ came to Medina and found that its inhabitants were paying in advance for buying dates and fruits against deferred delivery of one and two years. The Prophet (PBUH) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ said:

> *"Whoever pays for dates on a deferred delivery basis (Salam) should do so based on specified scale and weight" (Bukhari and Muslim)*

**(d) Stages of Salam**

**i. Master Salam Agreement:**

The client agrees with the bank whereby the details regarding the quantity, quality, price and the date of delivery of the commodity are agreed upon by both parties.

**ii. Advance Payment:**

The buyer/client agrees to deliver goods to the bank at a predetermined delivery date against the full payment made by the bank on the spot. The payment is made at the time when the Salam contract is entered into by both parties. The proceeds of the contract are used by the seller to finance the production or purchasing of agricultural inputs like seed, fertilizer, pesticides etc**.**

**iii. Delivery at a Future Date:**
The client delivers the specified commodities to the bank on the due date. After getting the goods, the bank either sells the goods in the market or sells the goods to a third party by entering a parallel salaam contract.

**iv. Parallel Salam Transactions:**
After purchasing the commodity from the client through Salam, the Bank can enter into another parallel Salam contract with the third party to sell the commodity purchased for the same date of delivery. The period in the second Salam contract is higher than the first Salam contract and the price is higher in case of parallel contract. The difference between the two prices is the profit of the bank.

### (e) Shariah Rulings of Salam

According to the rule of Islamic sale, the subject matter of the goods to be transacted must be existent at the time of sale, must be in the ownership of the seller, and must be in the physical or constructive possession of the seller. Salam (and Istisna) is the exception to these rules of sale to facilitate certain types of businesses.

i. The subject matter, price, and quantity should be precisely specified in the contract.
ii. Delivery of goods, place and time of goods delivery must be specified.
iii. Salam contact is applicable in the case of those commodities whose quantity and quality can be specified.
iv. Payment should be on the spot. It cannot be delayed as it will be considered as debt for debt.
v. Salam cannot be applied to a particular commodity, fruits of a particular tree or output of a particular farm.
vi. Both Salam contracts i.e., Salam and parallel Salam must be independent of each other.
vii. Parallel Salam is only allowed with the third party.

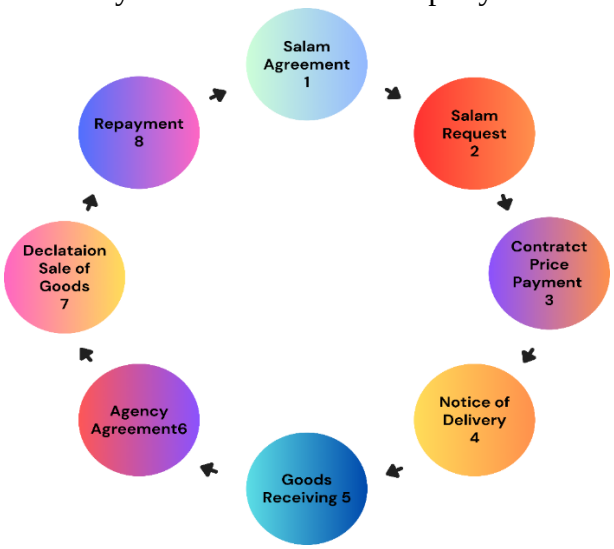



**Figure 4.4: Stages of Salam Contract**
**Source: Self-created**

### 4.2.4 Istisna

**(a) What is Istisna?**

Istisna means to order the manufacturer to manufacture or construct something. Istisna is a financing instrument used to finance the manufacturing of specific commodities. It is an agreement in which one party, (the purchaser) places an order to the other party (the manufacturer) to manufacture, build or construct any specific asset or commodity to be delivered at a future date at a mutually agreed price.

**(b) Uses of Istisna**

Istisna is used in;

i. Financing for raw materials.
ii. House financing,
iii. Project Financing
iv. Manufacturing of goods
v. Construction of highways, streets, apartment buildings, hospitals, schools and universities, dams etc.
vi. Financing high technology industries such as the aircraft industry and shipbuilding industries.
vii. Working capital and export financing.
viii. Housing finance schemes,
ix. BOT (Buy, operate, transfer) arrangement.

**(c) Shariah Legitimacy of Istisna**

According to Bukhari (5/220), Prophet Muhammad (PBUH) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ asked for the production of a golden ring. Additionally, in another hadith recorded in Bukhari (2/908), the Prophet (S.A.W) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ instructed the construction of a pulpit for preaching."

"The legitimacy of Istisna' is acknowledged by modern Shariah authorities, including the Council of the Islamic Fiqh Academy. This recognition was affirmed during its 7th session convened in Jeddah, Kingdom of Saudi Arabia, from 9th to 7th May 1992."

**(d) Stages of Istisna Contract**

The Istisna contract could be directly between the purchaser and the manufacturer. Typically, it is a contract in which three parties are involved. The third party is the bank which acts as an intermediary. Under the first Istisna' contract, the client makes payment to the bank, whereas under the second contract, the bank (as a buyer and financer) makes instalment payments to the manufacturer/contractor.

**i. Master Istisna Agreement**

The customer/buyer enters the Master Istisna Agreement with the bank and places an order to the bank for the manufacturing of any product or construction of the asset. The parties involved in the Istisna contract i.e. the purchaser and the bank agree on the specification and details of the assets/goods to be manufactured, the time, the quantity, and the delivery date.

**ii. Demand of Security**

According to the volume of the financing required, the bank asks the buyer to provide collateral to the bank which will serve as security against default by the purchaser.

**iii. Istisna price**

The purchase makes payment to the bank either lump sum or in the form of instalments. The instalment schedule may be tied to the different stages of manufacturing. The parties agree on the price of the subject matter to be manufactured and the payment terms.

**iv. Parallel Istisna with contractor**

The bank enters into a parallel Istisna contract with the contractor/ manufacturer to manufacture goods requested by the client of the bank. The parallel listing contract specifies the details of the

a. Time required to manufacture and deliver the goods.
b. completion date and any intermediate progress and milestones
c. the payment which the financer (bank) pays to the contractor based on the progress of the work.

**v. Ownership of the manufactured commodity**

Once the manufacturing or construction is completed, the contractor delivers the finished assets or goods to the financer (bank) as specified in the contract. At this stage, the ownership of the assets is with the bank.

**vi. Ownership transfer and delivery to the client**

Once the goods are manufactured and are transferred to the ownership of the bank, the client (the purchaser) makes the final payment, if any, to the bank and gets the delivery and title of the goods or the assets.

**(e) Shariah Ruling of Istisna Contract**

i. The subject matter of Istisna is assets/goods which need manufacturing.
ii. Istisna contract is invalid for natural things like animals, corn, fruit, etc.
iii. Manufacturer/contractor uses his own raw material and labour to manufacture the goods.
iv. Quality and quantity of subject matter should be agreed upon in absolute terms.
v. Istisna's price should be fixed with mutual consent.
vi. The contract of Istisna can be cancelled unilaterally before the manufacturer starts working but as the work starts Istisna cannot be cancelled unilaterally.
vii. Parallel Istisna is allowed with third party only.

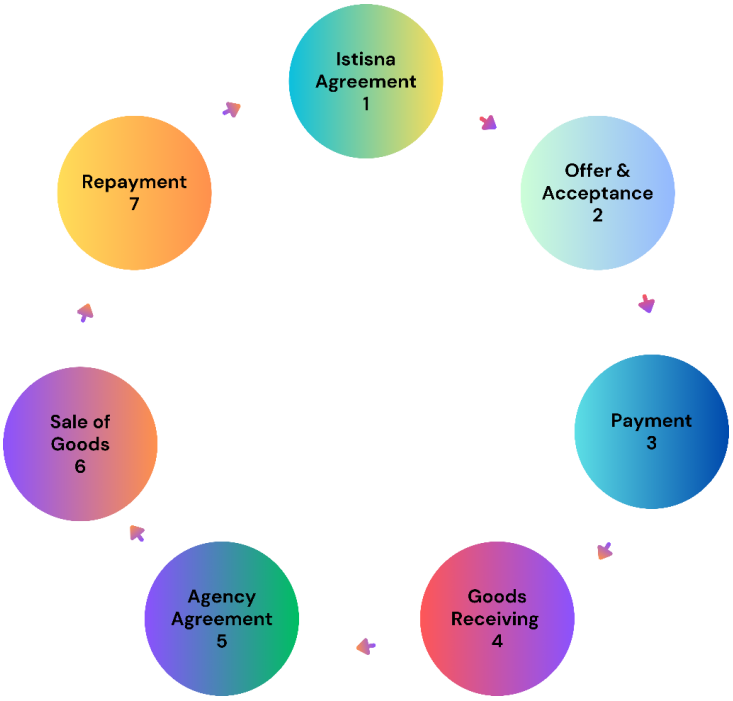



**Figure 4.5: Stages of Istisna Contract**
**Source: Self-created**

## 4.3 Lease-Based Modes

In a leasing agreement, the bank (lessor) purchases an asset and gives the right to use that property /object to the other party (lessee) at some agreed-upon rent for some specified period. In Islamic finance, all those assets that are not consumed during their use can be given as a lease. It includes an operating lease in which the tenant or the lessee pays for the use of the leased property after which the contract is completed, a financial lease in which the lessee pays the rent for the use of the assets and purchases the asset from the lessor through a separate contract of sale. In Islamic finance, the lease-based modes are strictly according to the Shariah principles.

### 4.3.1 Ijara

**(a) What is Ijara?**

Ijarah is an Arabic word which means "to give something or some service in return for some consideration". Ijarah is a lease-based mode based on Islamic principles in which an Islamic bank purchases an underlying asset on behalf of the client and rents it to the client afterwards. It is the contract of sale of usufruct (right to use an asset) for a specific period. The client who uses the asset is called the lessee and the bank who purchases the asset and transfers its usufruct to the client is called the lessor.

**(b) Uses of Ijara**

In Ijarah the subject matter of usufruct is divided into two types:

**i. Goods Usufruct**

It is the most common ijarah contract in Islamic finance, in which one party transfers the usufruct of the assets to the other party for agreed time against agreed consideration (rent) e.g. property or assets, like houses, vehicles, residences,

**ii. Service Usufruct**

In this ijarah contract, one party provides services to the other party and against those services Ujrah or remuneration of services (wages) is paid by the second party e.g. work of an engineer, doctor, tailor, carpenter, etc.

**(c) Shariah Legitimacy of Ijarah**

Shariah legitimacy of Ijarah is evidenced by the Quran, Sunnah, and the consensus of scholars.

Allah says in the Holy Quran;

*"If they will breastfeed for you, then give them their payment…" Surah Talaq (65:6)*

*"One of the women said, "O my father, hire him. Indeed, the best one you can hire is the strong and trustworthy." Surah Al-Qasas (28:26)*

Hadith of Muhammad (S.A.W.) حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ provides evidence regarding the permissibility of the sale of usufruct.

*Abdullah bin 'Umar narrated that the Messenger of Allah Prophet Muhammad (ﷺ) Khaataman Nabiyyeen* حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ *said: "Give the worker his wages before his sweat dries."*

*Abu Huraira also narrates that: "The Prophet Muhammad (ﷺ) Khaataman Nabiyyeen* حضرت مُحَمَّدٌ رَسُولُ اللهِ خَاتَمُ النَّبِيِّيْنَ صَلَّى اللهُ عَلَيْهِ وَعَلٰى آلِهٖ وَاَصْحَابِهٖ وَسَلَّمَ *said, "Allah, the Exalted, says: 'I will contend on the Day of Resurrection against three (types of) people: One who makes a covenant in My Name and then breaks it; one who sells a free man as a slave and devours his price; and one who hires a workman and having taken full work from him, does not pay him his wages."*

**(d) Stages of Ijarah**

Ijarah's contract typically includes the following stages.

i. **Master Ijara Agreement:**

The customer and the bank enter into a Master Ijara agreement in which the bank purchases an underlying asset based on the specification of the client and transfers the right to use the asset to the client. The time duration and the identification of the asset are agreed upon by both parties. The lessor also determines the cost (market value) of the asset to determine the rental amount for the lease period. Rental payments may be monthly, quarterly, or any term mutually agreed upon. The responsibilities and obligations of both the lessor and lessee are also laid upon in the agreement.

ii. **Purchase of the underlying asset:**
The bank purchases the asset from the market, acquires the title of the assets and makes payments to the vendor.

iii. **Transfer of Possession & Payment of Rentals:**
The bank then leases the assets to the lessor and the possession of the assets is transferred to the lessor against the rentals for the agreed lease period.

iv. **Return or Purchase Option:**
After receiving all the rentals as per the Ijara arrangement and the expiry of the duration of the contract the customer returns the underlying asset to the bank. At this stage, the bank under the separate contract offers to sell the underlying asset to the lessor at the predetermined price of the residual asset.

**(e) Shariah rulings of Ijarah**

i. The subject matter of usufruct must be specified.

ii. The terms and conditions of the Ijara contract, which includes time, rental amount should be specified and agreed upon at the time of the contract.

iii. The assets must be under the ownership of the lessor for the entire lease period.

iv. The lessee is entitled to use the asset against payment of the agreed-upon rental only for the purpose specified in the agreement.

v. The lessor is also responsible for bearing all the risks associated with ownership, such as asset maintenance, but the lessee will be responsible for the loss to the Ijara capital if the loss is caused by his negligence.

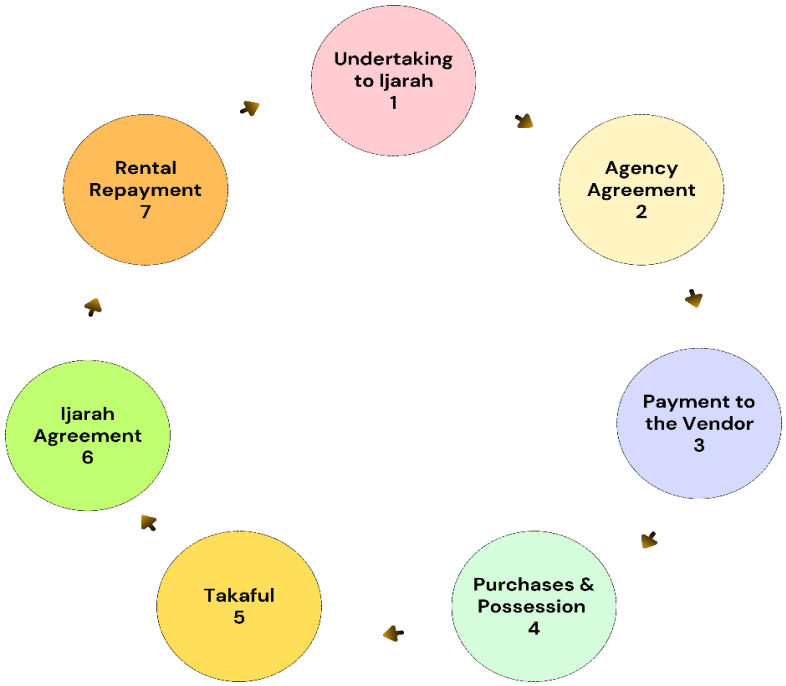



**Figure 4.7: Stages of Ijarah Contract**
**Source: Self-created**

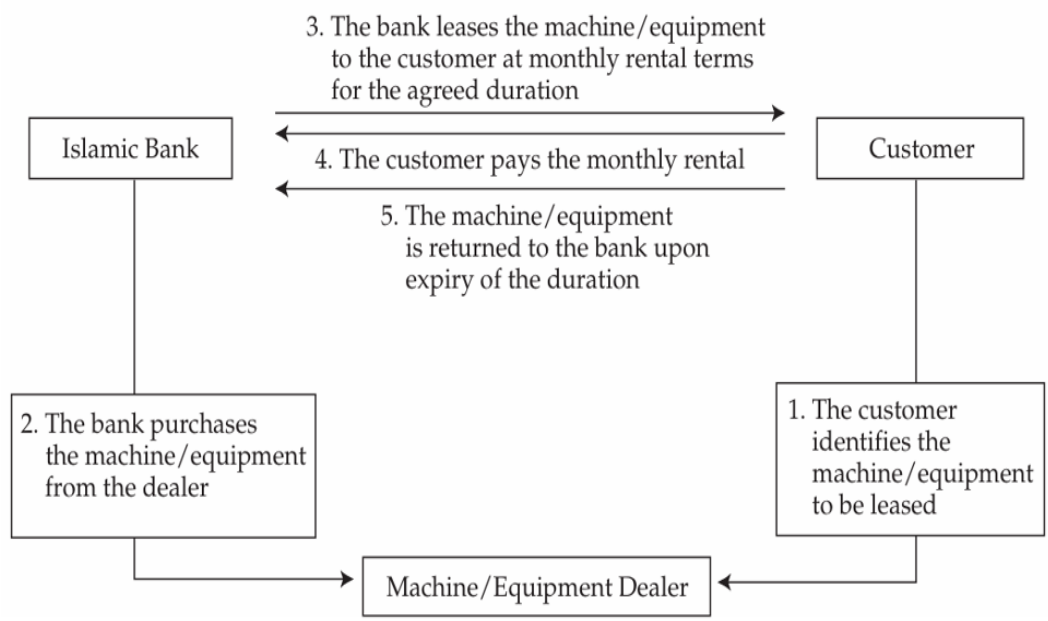



**Figure 4.6: Structure of Ijara Financing**
**Source: Book: A Primer on Islamic Finance**

## 4.4 Profit and Loss Sharing Modes

Profit and Sharing modes are also used by Islamic banks as financing instruments. PLS modes are based on the principles of risk and return sharing and equity participation. There are three types of PLS sharing modes used by Islamic banks for financing activities.

### 4.4.1 Mudarabah

In the Mudarabah contract one party, the bank (the financer) provides capital to the other party (the entrepreneur) to transact the business using his expertise. The profit of the venture is shared between the bank and the entrepreneur as per the agreed ratio and the losses are borne by the bank provided, they are not due to the entrepreneur's misconduct, negligence, or breach of contract terms.

**(a) Uses of Mudarabah**

i. Management of mutual funds
ii. project financing,
iii. bridge financing,
iv. working capital
v. SME financing

**(b) Stages of Mudarabah Financing**

Mudarabah financing in Islamic banking is the contract of partnership between the bank (Rab ul-Maal) and the entrepreneur (Mudarib) according to the Shariah principles. Here are the general steps involved in Mudarabah financing in banking:

i. **Customer's Request:**
The entrepreneur or customer approaches the Islamic bank with a proposal for a business venture or investment opportunity. The customer provides details about the nature of the project, the required financing amount etc.

ii. **Evaluation by the Bank:**
The Islamic bank conducts a thorough evaluation of the proposed business venture, including the viability of the project, the entrepreneur's experience and expertise, and the potential risks involved. This step ensures that the proposed venture complies with Shariah principles and aligns with the bank's risk appetite.

iii. **Mudarabah Agreement:**
Once the business proposal is approved, the Islamic bank and the entrepreneur enter a Mudarabah agreement. The agreement outlines the terms and conditions of the Mudarabah partnership, including the investment amount, profit-sharing ratio, the duration of the partnership, and the roles and responsibilities of each party.

iv. **Investment Disbursement:**
The Islamic bank provides the capital (funds) for the business venture based on the terms of the Mudarabah agreement.

v. **Business Operations:**
The entrepreneur is responsible for managing the day-to-day operations of the business by the Mudarabah agreement. Entrepreneurs contribute their skills, labour, and expertise to manage and operate the business.

vi. **Profit Distribution:**
At the end of the Mudarabah period, profits generated from the business venture are shared between the Islamic bank and the entrepreneur based on the pre-agreed profit-sharing ratio outlined in the Mudarabah agreement. The entrepreneur receives a share of the profits as compensation for their labour and expertise, while the bank receives a share of the profits as a return on its investment.

vii. **Loss Sharing:**
In case of any losses incurred during the Mudarabah period, the Islamic bank bears the entire loss, while the entrepreneur does not bear any financial loss but may lose the opportunity cost of their time and effort invested in the venture.

viii. **Termination of Mudarabah:**
The Mudarabah agreement is terminated either upon the completion of the business venture, expiration of the agreed-upon Mudarabah period, or by mutual agreement between the parties. At the time of termination, profits are distributed according to the profit-sharing ratio.

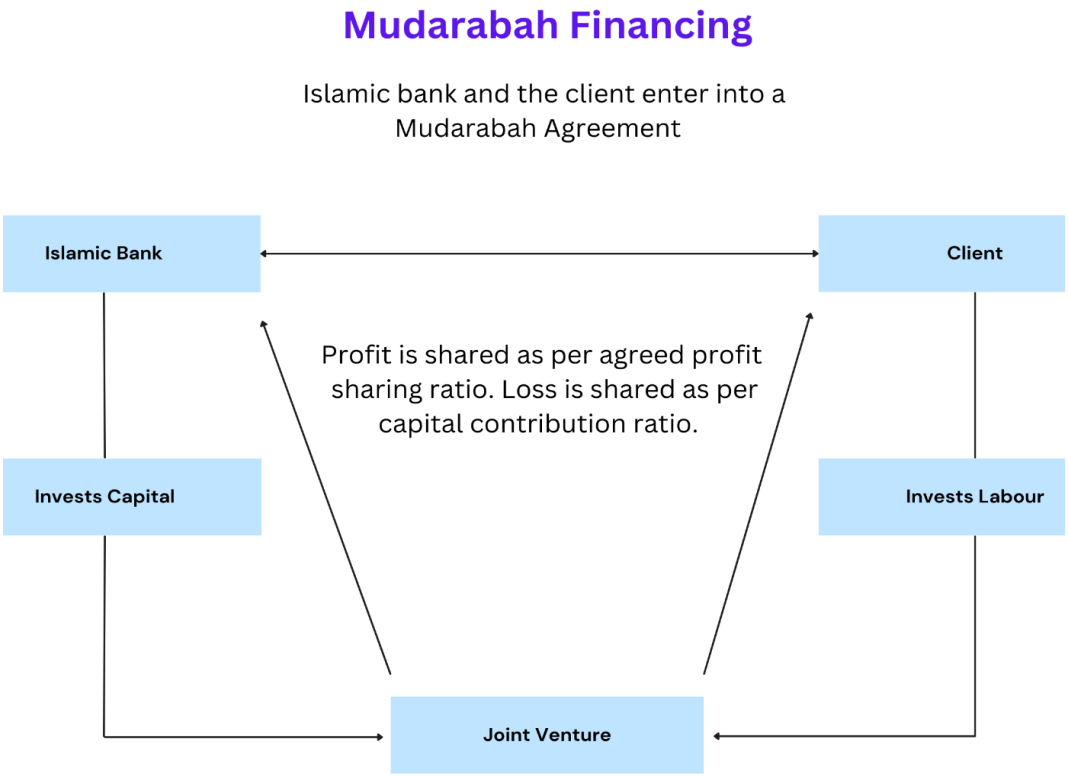



**Figure 4.8: Mudarabah Financing**
**Source: Google**

### 4.4.2 Musharakah

Musharakah is a contract of partnership where the partners jointly contribute capital to finance a project or to undertake any business. The bank undertakes joint ownership with the client to undertake any business. The partners can participate in the management of the business. The profits are shared according to the agreed ratio and the losses are shared according to the capital contribution.

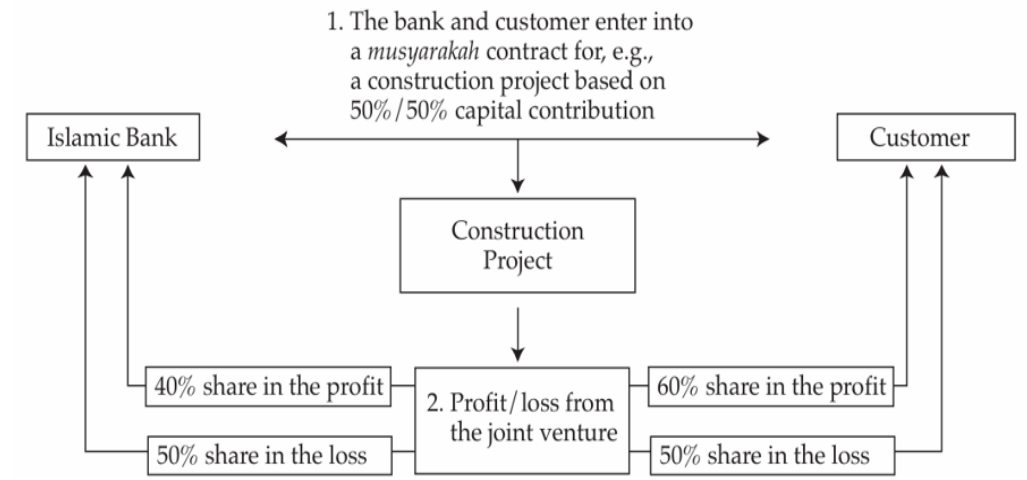



**Figure 4.10: Structure of Mushakarah Financing**
**Source: Source: Book: A Primer on Islamic Finance**

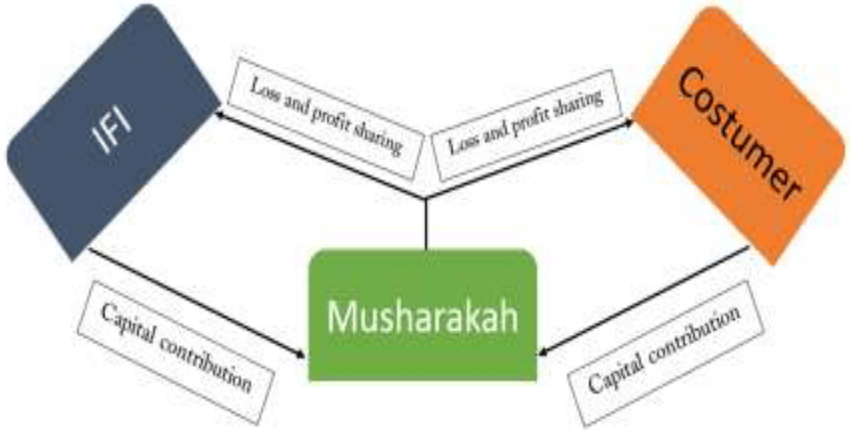



**Figure 4.9: Musharakah Financing**
**Source: Google**

**(a) Use of Musharakah**

i. Corporate Financing
ii. Joint venture
iii. Project financing
iv. Trade financing

### 4.4.3 Diminishing Musharaka

**(a) What is Diminishing Musharakah?**

Diminishing Musharakah is a Shariah-based partnership agreement used for Islamic financing. The bank and the customer jointly own the asset and the one partner (customer) gradually purchases the share of the other partner (the bank) until the ownership of the property or the asset is completely transferred to the client. It includes two contracts, the lease contract and the diminishing Musharakah contract.

**(b) Use of Diminishing Musharakah**

i. Financing real estate
ii. House financing

**(c) Stages of Diminishing Musharakah**

Here's how Diminishing Musharakah typically works:

i. **Partnership Agreement:**
The bank and the customer enter into a partnership agreement to jointly own a particular asset. The bank purchases the assets and leases them to the customer based on an ijarah contract.

ii. **Capital Contribution:**
Some portion of the capital is contributed by the bank, and the remaining amount is paid by the customer.

iii. **Rent Payments:**
The customer pays rent to the bank for the use of the assets.

iv. **Gradual Transfer of Ownership:**
The ownership stake of the bank is divided into a specified number of units, and the client purchases these units gradually within a specified time. With each periodic payment to the bank, the bank's share in the ownership of the asset decreases and that of the customer increases. This process continues until the customer becomes the sole owner of the asset and the title of the asset is transferred to the customer.

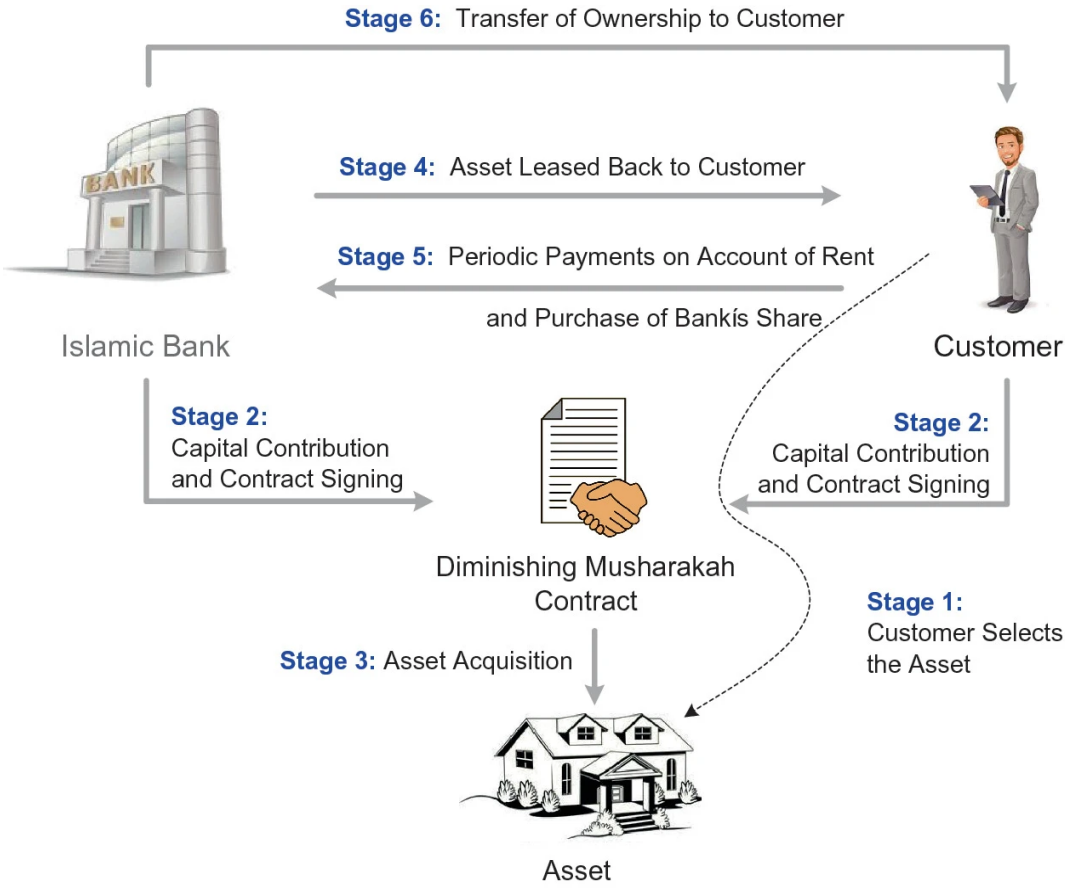



**Figure 4.10: Diminishing Mushakarah**
**Source: Google**

## SUMMARY

In this unit, we have provided a comprehensive overview of financing in Islamic banks, emphasizing the various modes of Islamic finance. We began by discussing the foundational principles of Islamic banking and finance, rooted in Shariah law. Subsequently, we explored trade/sale-based modes such as Murabahah, Salam, and Istisna, elucidating their mechanisms and applications in Islamic banking transactions. Following this, we delved into the lease-based mode of financing, Ijara, and its significance in Islamic finance. Lastly, we examined profit and loss-sharing modes, including Mudarabah, Musharakah, and Diminishing Musharakah, highlighting their role in fostering the risk-sharing and equitable distribution of profits. Through this exploration, we have gained insight into the diverse range of financial instruments employed in Islamic banking, reflecting its adherence to ethical principles and risk-sharing mechanisms in financial transactions.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
   i. What is a Trust sale?
   ii. What are the rules defined by Shariah regarding the sale contracts?
   iii. What is Ijarah?
   iv. What do the financing activities of an Islamic bank consist of?
   v. What are the uses of the Salam contract?

2. Write long notes on the following questions.
   i. Write a detailed note on the Murabahah contract.
   ii. What are profit and loss-sharing modes of financing? Explain in detail.
   iii. Write a note on the lease-based mode of financing.

3. Please fill in the blank spaces.
   i. ……is the form of sale that entails setting the selling price equivalent to the initial purchase cost.
   ii. ……is the financing instrument used by Islamic banks to finance and facilitate agriculture transactions.
   iii. Istisna means to…….
   iv. In……. contract one party, the bank (the financer) provides capital to the other party (the entrepreneur) to transact the business using his expertise.
   v. ……is a contract of partnership where the partners jointly contribute capital to finance a project or to undertake any business.

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**Unit–5**

# RISK MANAGEMENT FOR ISLAMIC BANKS

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**Reviewed by: Dr. Muhammad Suleman Afzal**

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# INTRODUCTION

Risk management is a critical aspect of banking operations which ensures the stability and sustainability of financial institutions. In Islamic banking, risk management takes on unique dimensions due to the adherence to Shariah principles and the prohibition of certain conventional financial instruments. This unit discusses the nature of risk and the fundamental principles of risk management, the unit navigates through the diverse types of risks that the Islamic banks are exposed to, emphasizing the significance of Shariah compliance. This unit offers insights into the strategies and tools utilized to effectively mitigate risks while safeguarding ethical integrity. Furthermore, the unit highlights the pivotal role played by regulatory frameworks and governance structures in fostering sound risk management practices, essential for the stability and sustainability of Islamic banking institutions.

# OBJECTIVES

At the end of this unit, you will be able to:

i. Examine the principles of risk management in Islamic banking, considering Shariah compliance and ethical considerations.

ii. Identify and analyze the various types of risks faced by Islamic banks, including credit risk, market risk, liquidity risk, and operational risk.

iii. Discuss the strategies and tools employed by Islamic banks to mitigate and manage risks effectively.

iv. Highlight the role of regulatory frameworks and governance structures in ensuring sound risk management practices in Islamic banking.

## 5.1 What is Risk?

Risk refers to the probability of occurrence of an event that could result in adverse consequences or losses. It involves uncertainty about the outcome of future events and the potential impact of these uncertain future events. Risks may arise from various sources which include financial systems, economic conditions, operational activities, regulatory changes, natural disasters, and human factors.

## 5.2 What is Risk Management?

Risk management is the process of identifying, assessing, prioritizing, and mitigating risks to minimize the impact of the risk on an organization's activities and operations. It involves systematically analyzing potential threats and opportunities, determining the likelihood and potential consequences of each risk, and developing strategies to manage or mitigate them effectively.

## 5.3 Nature of Risk in Islamic Banking

Islamic banking framework is based on Shariah which is the set of rules that govern the processes, mechanisms, and the execution of Islamic banking activities. The theoretical background of Islamic banks requires them to undertake activities and transactions within the limitations of Shariah guidelines. The assets and liabilities side of Islamic banking exhibits some unique features not common to the interest-based bank. On the liability side, Islamic banks maintain demand deposits, saving and investment deposits. On the assets side, Islamic banks use both profit and loss-sharing modes and sale-based modes of financing. The Islamic banking model consists of instruments that have inherent features of risk and return sharing, still, Islamic banks are exposed to certain risks due to the nature and management of Islamic banking instruments and Shariah restriction while funding and investment activities, and, on other hand, relations, and obligations of Islamic banks towards their depositors expose them to the risk which are different from the conventional banks. Even if Islamic banking operates on Shariah principles, they are not insulated from the risk. They require risk management and adherence to Shariah principles.

## 5.4 Principles of Risk Management in Islamic Banking

Risk management in Islamic banking is guided by principles of Shariah compliance and ethical considerations, contributing to a more resilient and sustainable financial system. By adhering to these principles, Islamic banks can effectively mitigate risks while promoting ethical conduct and societal well-being.

**i. Shariah Compliance:**

Risk management in Islamic banks is guided by Shariah principles such as

a. **Prohibition of Riba (Interest):**
   Risk management practices should ensure that interest-free financing models are employed to mitigate the risk of non-compliance with Shariah law.

b. **Avoidance of Gharar (Uncertainty) and Maisir (Gambling)**:
   Islamic banking risk management strategies prioritize investments in assets with tangible value and real economic utility, reducing the risk of asset bubbles and market volatility.

**c. Risk Sharing:**
   Risk management practices focus on promoting risk-sharing arrangements to align the interests of the bank with those of its customers.

**ii. Ethical Considerations**:

**a. Adherence to Ethical Standards:**
   Risk management practices prioritize ethical considerations, ensuring that financial products and services comply with Islamic ethical principles which include ethical conduct and integrity in all financial transactions.

**b. Social Responsibility:**
   Risk management strategies incorporate social responsibility considerations to mitigate reputational and social risks.

**c. Fair Treatment of Stakeholders:**
   Risk management practices aim to protect the interests of stakeholders and promote equitable outcomes in financial transactions.

## 5.5 Type of Risks in Islamic Banking

Islamic banking is relatively new and exposed to different types of risks. This section discusses different risks that Islamic banks are exposed to along with the guiding Principles issued by the Islamic Financial Services Board (IFSB) which provides a set of guidelines of best practice for establishing and implementing effective risk management in Islamic financial institutions.

### 5.5.1 Credit Risk

Credit risk is the risk that the counterparty (to whom Islamic bank are providing their financing) fails to meet their financial obligations according to the agreed terms. Credit risk may arise in the settlement and the clearance of the transactions. Islamic banks may face credit risk in instruments such as Murabahah, Diminishing Musharakah, and Ijarah, Salam, Istisna, or Mudharbah.

For example, in sale based and lease-based modes the credit risk arises when the buyer defaults in the payment of agreed amount on time, it may arise due to the asymmetric information when either the funds provided are not invested for the purpose for which they are acquired or when the customer willfully defaults.

In the case of profit-sharing modes of financing, the credit risk may arise when the entrepreneur fails to pay share of the bank when it is due. This issue may occur for banks in these situations due to the problem of asymmetric information, where they lack adequate knowledge about the firm's actual profit.

Credit risk arises in institutions that:

- Have financing exposures to receivables and leases, such as Murabahah, Diminishing Musharakah, and Ijarah.
- Manage working capital financing transactions and projects, such as Salam, Istisna, or Mudharbah.

**Credit Risk Management Principles**

**Principle 1:** To manage risks effectively in Islamic banking, institutions must implement a comprehensive risk management and reporting process. This process should adhere to Shariah rules and principles and ensure reporting to the supervisory authority.

**Principle 2:** Institutions should develop a financing strategy using various Shariah-compliant instruments to identify potential credit exposures at different stages of financing agreements.

**Principle 3:** Institutions must conduct a due diligence review before selecting an appropriate Islamic financing instrument.

**Principle 4:** Institutions should establish a suitable methodology to measure and report potential credit risk associated with each Islamic financing instrument for optimal risk management in Islamic banking.

**Principle 5:** Institutions must employ Shariah-compliant techniques to mitigate credit risk. These techniques should include:

- A methodology for setting mark-up rates based on risk ratings, ensuring that expected risks are considered in pricing decisions.
- Permissible and enforceable collateral and guarantees
- Clear documentation regarding the cancelability of purchase orders
- Clear procedures for governing laws applicable to financing transactions.

### 5.5.2 Equity Investment Risk

Equity risk arises when Islamic banks enter Musharakah and Mudârabah partnerships as providers of funds and they share in the business risk of the activity being financed.

**Equity Investment Risk Management Principles:**

**Principle 6:** Islamic financial institutions must have appropriate risk management and reporting processes tailored to the risk characteristics of equity investments, including Mudarabah and Musharakah.

**Principle 7:** For effective security risk management in Islamic finance, Islamic banking institutions should ensure their valuation methodologies are appropriate and consistent. They must also assess the potential impacts of these methods on profit calculations and allocations.

**Principle 8:** To achieve ideal Shariah-compliant risk management in Islamic finance, institutions should establish exit strategies for their equity investment activities, subject to the approval of the institution's Shariah Advisor.

### 5.5.3 Market Risk

Market risk refers to the potential for losses in both on-balance and off-balance sheet positions due to changes in market prices. This includes fluctuations in the values of tradable, marketable, or leaseable assets (such as sukuk) and individual portfolios not listed on the balance sheet. The risk is associated with the current and future volatility in the market values of specific assets, such as the commodity price of a Salam asset, the market value of a sukuk, the market value of Murabahah assets scheduled for future delivery, and the foreign exchange rate.

Market risk can be systematic, arising from macro sources e.g. currency and equity price risks, or unsystematic, being asset or instrument-specific e.g. movement in prices of commodity or asset the bank is dealing with

#### (a) Mark-up Risk

Islamic banks use a benchmark rate to price their assets which is known as the markup price, which is being charged in instruments. As Islamic banks price their instruments using interbank rates any change in the rate causes changes in the value of the instruments such as Muarabaha, Mudaraabah and Muskarakh. For instance, in a Murabaha contract, the mark-up is calculated by adding the risk premium to a benchmark rate, typically the LIBOR. The Murabaha contract has a fixed mark-up for its duration. Therefore, if the benchmark rate changes, the markup on these fixed-income contracts remains unchanged. This exposes Islamic banks to risks

from fluctuations in market interest rates. Mark-up risk can also arise in profit-sharing financing modes like Mudaraba and Musharaka, as the profit-sharing ratio is influenced by factors including a benchmark rate like LIBOR.

**(b) Commodity Price Risk**

Islamic banks also face commodity price risk due to changes in the prices of the commodities or durable assets as in Salam and Ijara etc**.**

It is important to note that both mark-up risk and commodity/asset price risk can coexist within a single contract. For example, in a leasing arrangement, the equipment is subject to commodity price risk, while the fixed or overdue rentals are subject to mark-up risk.

**Market Risk Management Principle**

**Principle 9:** Institutions must establish an appropriate framework for market risk management, including the reporting of all assets held.

### 5.5.4 Liquidity Risk

Liquidity risk is the risk that Islamic banks are unable to obtain cash at a reasonable cost (funding liquidity risk) or they are unable to convert their assets into cash quickly at a fair market price (asset liquidity risk). Islamic banks are exposed to liquidity risk due to Shariah restrictions in obtaining funds quickly from the market at interest as Islamic banks are not available in Islamic inter-bank money market. The existing liquidity management facilities are based on interest, therefore Islamic banks cannot use them to meet their liquidity need which increases their liquidity risk.

This risk is increased in Islamic banks due to several factors, including:

a. their reliance on short-term retail funding
b. their operation in environments with underdeveloped Shariah-compliant interbank and money markets, as well as government securities
c. their limited ability to hedge certain risks due to prohibitions against using conventional derivatives
d. their limited access to lender-of-last-resort facilities. Islamic banks are also unable to undertake lender of last resort facility to meet their emergency liquidity needs.

**Liquidity Risk Management in Islamic Banks**

**Principle 10:** Institutions must have a liquidity management framework that includes reporting both separately and on an overall basis. This framework should account for their liquidity exposures concerning each category of current accounts and PLS deposits.

**Principle 11:** Institutions should assume liquidity risk in line with their capacity to access sufficient Shariah-compliant funds to mitigate such risk.

### 5.5.5 Rate of Return Risk

The rate of return risk occurs when an increase in benchmark rates leads to expectations of higher returns on investment accounts. However, the actual rate of return cannot be precisely determined until the end of the investment holding period.

**Rate of Return Management in Islamic Banks**

**Principle 12:** Institutions must establish a reporting process to assess market factors that impact the rates of return on assets, compared to the expected rates of return for investment account holders (IAH).

### 5.5.6 Displaced Commercial Risk

Displaced commercial risk stems from the rate of return risk. It occurs when an Islamic bank feels compelled to offer its investment account holders (IAHs) a higher rate of return than what is stipulated under the actual terms of the investment contract. This is done to prevent IAHs from withdrawing their funds to invest elsewhere. Displaced commercial risk arises when Islamic banks operate in compliance with the Shariah principles and are not able to pay competitive rates of return to the depositors. It refers to the risk of a mismatch between the return paid to the depositors versus the return earned on financing activities. If the return from the financing activities is less it may lead to insufficient funds to meet the obligations of the depositors, which increases the risk of withdrawal. To minimize the risk of withdrawal, the owners of the banks/shareholders forgo a part of their profit to pay the depositors to the investment depositor.

**Displaced Commercial Risk Management in Islamic Banks**

**Principle 13:** Institutions must have an appropriate framework for managing displaced commercial risk, where applicable.

### 5.5.7 Operation Risk

Operational risk is the risk faced by Islamic banks which arises due to inadequacy or failure of internal processes, operational practices, people, and system technology. Due to the very short history of Islamic banks, they are exposed to greater operational risk as compared to conventional banks. Islamic banks face operational risk due to the shortage of qualified professionals having expertise in both banking and Shariah. Systems and technology used in Islamic banks require more specialization due to the nature of the business of Islamic banks. It also arises while conducting Islamic financial operations according to Shariah principles. Applying the PLS modes in

financing activities (assets side) exposes Islamic banks to agency problems and the need to exercise additional control over the borrowers as the financer (IB here) has no monitoring right over the finances. Management of non-PLS modes (sale-based modes, lease-based modes) forces IBs to have increased monitoring and administration costs ultimately exposing them to additional operational risks. Due to differences across countries in the interpretation and application of Shariah ruling in different permissible financial products also arises operational risk and legal uncertainty in cross-border Islamic financial activities.

**Operational Risk Management in Islamic Banking**

**Principle 14:** Institutions must ensure they have adequate systems and controls in place, including compliance with Shariah rules and principles, supported by a Shariah Advisor.

**Principle 15:** Institutions should have appropriate mechanisms to protect the interests of all fund providers. Specifically, for IAH holders, institutions must ensure that the bases for asset, revenue, expense, and profit allocations are properly applied and reported.

### 5.5.8 Transactional risk

Transactional risk arises when the change in the sequence or the structure of any transactions causes the transaction to be invalid, e.g., the sequence of Muarabah contract. If the Murabah contract is not followed in the right sequences that will make the transaction invalid and result in the loss of income

### 5.5.9 Withdrawal risk

Sharing losses or providing returns lower than conventional banks' returns exposes Islamic banks to withdrawal risk. Islamic banks do not provide guaranteed returns to the investors, but the returns are tied to the productivity of the investment. When Islamic banks provide variable returns, they are exposed to the withdrawal risk which arises when Islamic bank depositors withdraw their deposits from their Islamic banking accounts and keep their accounts in the bank paying more returns.

### 5.5.10 Shariah Non-Compliance Risk

Shariah Non-compliance risk is the risk that arises if transactions or activities are not in accordance with the Islamic principles. The existence and the operation of Islamic banks are dependent on the compliance of their activities with the Shariah principles, and the activities should be approved by the Shariah advisory board of the bank. Failure to the compliance with the activities to the Shariah requirements deems Islamic banking business as non-Shariah compliant business. Inadequate compliance with Shariah law can undermine consumer protection due to fraudulent

activities and misinterpretations of fundamental Shariah principles. If depositors lose confidence in the Shariah compliance of Islamic banks, the bank could encounter financial problems, beginning with liquidity issues and potentially escalating to solvency problems. If the Islamic bank is large and well-connected, these issues could become systemic.

### 5.5.11 Legal Risk

Legal risk arises from the lack of consensus among Islamic scholars regarding Shariah-compliant transactions, leading to significant legal uncertainty. The absence of standardized contracts and differing criteria for Shariah-compliant agreements further increases legal risk for Islamic banks.

### 5.5.12 Fiduciary risk

Fiduciary risk can arise from an Islamic bank's breach of contract. For instance, the bank may fail to fully adhere to Shariah requirements in various contracts. This non-compliance, whether intentional or unintentional, can erode depositor confidence and lead to withdrawals. Additionally, offering a lower rate of return than the market can introduce fiduciary risk if depositors or investors perceive it as a breach of the investment contract or mismanagement of funds by the bank (AAOIFI, 1999).

### 5.5.13 Transparency Risk

Transparency risk in Islamic banks can result in losses due to poor decisions stemming from incomplete or inaccurate information. It is exacerbated by non-standard reporting conventions for Islamic financial contracts and inconsistencies in reporting standards across banks. These differences in financial reporting, auditing, and accounting practices often stem from varying interpretations of Shariah rules.

## 5.6 Risk Management in Islamic Banking

Risk Management includes the prudent practices and the tools used by the banks for risk mitigation and good governance. The risk management framework for Islamic Banking institutions is inherently different from interest-based banks due to differences in the theoretical background of both banks. Risk management in Islamic banks involves strategies and frameworks that align with Sharia principles.

**i. Shariah Governance System**

Each bank has its own Shariah governance system which consists of a Shariah advisory board and committees. These boards consist of qualified Shariah scholars who review and approve banking products, transactions, and practices to ensure adherence to Shariah law. Strong corporate governance practices enhance transparency, accountability, and risk management effectiveness.

ii. **Capital Adequacy and Prudential Regulations**:
Regulatory frameworks impose capital adequacy requirements on Islamic banks to ensure they maintain sufficient capital buffers to absorb losses and mitigate risks. Prudential regulations set by regulatory authorities mandate risk management practices such as credit risk assessment, liquidity management, and market risk mitigation. By enforcing these regulations, regulators ensure that Islamic banks maintain financial stability and resilience against systemic risks.

iii. **Governance and Internal Controls**:
Regulatory frameworks establish governance requirements to ensure effective oversight, accountability, and risk management within Islamic banks. Boards of directors are responsible for setting strategic objectives, overseeing risk management practices, and ensuring compliance with regulatory requirements. Internal control mechanisms, such as risk committees, internal audit functions, and compliance units, are mandated to monitor and evaluate risk management processes and controls within Islamic banks.

iv. **Regulatory Supervision and Enforcement**:
Regulatory authorities conduct regular inspections, examinations, and audits to assess the financial condition, risk management practices, and compliance of Islamic banks. Supervisory interventions are initiated to address deficiencies, weaknesses, or violations identified during regulatory examinations, ensuring prompt remedial actions and corrective measures. Regulatory enforcement actions, including fines, sanctions, or license revocations, are imposed on banks that fail to comply with regulatory requirements or engage in risky or unethical practices.

v. **Takaful (Islamic Insurance)**:
Islamic banks utilize Takaful as an alternative to conventional insurance to mitigate various risks. Takaful operates on the principle of mutual assistance, where participants pool their resources to cover potential losses. By participating in Takaful schemes, Islamic banks can protect against risks such as property damage, liability etc.

vi. **Transparency and Disclosure**:
Regulatory frameworks require Islamic banks to maintain transparency in their operations and financial reporting. Banks are mandated to disclose information about their risk management practices, financial performance, and exposure to various risks to stakeholders, including customers, investors, and regulators. Transparent reporting enhances market discipline and facilitates informed decision-making by stakeholders, contributing to the stability and credibility of Islamic banks.

vii. **Liquidity Risk Management:**

Islamic banks collect most funds from demand deposits and maintain higher levels of mandatory reserves against these deposits to avoid sudden massive withdrawals and help them avoid liquidity risk. Islamic banks are constrained in using some of the risk mitigation instruments to manage their liquidity risk as they are not allowed to invest in interest-based transactions e.g. lender of last resort, interbank money market. Secondly, there are no shari'a-compatible short-term securities for liquidity risk management in most jurisdictions.

**viii. Credit Risk Management:**

Islamic banks conduct comprehensive credit assessments before extending financing. Islamic banks ask for collateral and guarantees to manage and minimize defaults by counterparties.

ix. **Market Risk Management:**

Islamic banks use Sharia-compliant risk management tools to hedge against market risks. Islamic banks also ensure that their investment portfolios are according to the Sharia principles.

x. **Operational Risk Management:**

Islamic banks are now taking steps to minimize their exposure to operational risk. It requires strong internal controls, monitoring the borrowers, and training staff and employees regarding Islamic banking and the legitimacy of contracts and instruments. To mitigate operational risks. It also includes regularly conducting audits and assessments of operational processes and systems. The IBs, due to their obligation to provide competitive returns to investors, and facing higher operational risk, are required to be more vigilant, which helps them in avoiding moral hazard and excessive risk.

xi. **Parallel contracts:**

To ensure sharia compliance in each contract Islamic banks enter parallel contracts such as parallel Istisna and parallel Salam. The purpose of entering parallel contracts is to ensure that the two contracts' main contract and the parallel contract remain independent of each other.

xii. **Maintenance of Reserves**

To mitigate displaced commercial risk, Islamic banks use a variety of prudential reserves

***a. Profit Equalization Reserve (PER):***

This is an amount set aside from investment profits before dividing them between shareholders and unrestricted investment account holders and before

deducting Islamic shares. It helps smooth out fluctuations in profit payouts on investment deposits, ensuring returns are consistent with market rates even when investment returns decrease, without reducing the bank's share.

***b. Investment rate reserve (IRR):***

IRR is maintained to cover future investment losses of account holders. This is an amount taken from the income of investment account holders after the bank's share is deducted. It serves to spread out income over time for investment accounts, helping to protect against future investment losses and maintain regular payout.

xiii. **Risk Sharing**

The risk-sharing feature also protects Islamic banks and mitigates credit risk as it provides the advantage of passing a negative shock on the asset side to the investment depositors. Islamic banks use risk-sharing contracts such as Mudarabah and Musharakah to distribute risk between the bank and its customers.

xiv. **Asset-Backed Financing**:

Islamic banks emphasize asset-backed financing, where financing is provided based on tangible assets or real economic activities. Asset-backed financing reduces credit risk by providing collateral, which the bank can liquidate in the event of default.

## SUMMARY

Risk management in Islamic banks involves navigating the complexities of financial markets while adhering to Shariah principles. This unit has provided an overview of the principles, challenges, and strategies involved in risk management within Islamic banking. We examined the various types of risks faced by Islamic banks and explored how these risks are managed while maintaining compliance with Shariah principles. Additionally, we discussed the importance of regulatory frameworks and governance structures in promoting sound risk management practices. By understanding the unique dynamics of risk management in Islamic banking, financial institutions can enhance their resilience and sustainability in an increasingly complex global financial landscape.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
   i. What is Risk?
   ii. What is the nature of risk in Islamic Banks?
   iii. What is Risk Management?
   iv. State the principles of risk management in Islamic banks.
   v. What are the different types of risks faced by Islamic banks?

2. Write long notes on the following questions.
   i. Type of Risks in Islamic Banking.
   ii. Explain the tools used by Islamic banks to mitigate and manage risks effectively.
   iii. What is the role of regulatory frameworks and governance structures in the risk management of Islamic banks?

3. Please fill in the blank spaces.
   i. ……refers to the probability of occurrence of an event that could result in adverse consequences or losses
   ii. …….. is the risk that the counterparty (to whom Islamic bank are providing their financing) fails to meet their financial obligations according to the agreed term.
   iii. …… risk arises when the change in the sequence or the structure of any transactions causes the transaction to be invalid
   iv. ……is the risk that arises if transactions or activities are not by the Islamic principles
   v. Regulatory frameworks require Islamic banks to establish…… to ensure compliance with Islamic principles.

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Islamic Financial Services Board Guiding Principles Of Risk Management For Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services https://www.ifsb.org/wp-content/uploads/2023/10/IFSB-1-December-2005_En.pdf

**Unit–6**

# THE ISLAMIC FINANCIAL MARKETS

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## INTRODUCTION

This unit explores the intricacies of the Islamic Financial Market and the mechanisms that govern financial transactions within Islamic finance principles. This unit will commence by examining the various categories of financial markets, serving as pivotal hubs for the exchange of capital and assets. Subsequently, we will discuss the Islamic Money Market, a domain where short-term financial instruments are traded by Islamic principles. Following this, the Islamic Capital Market facilitates longer-term investments aligned with Islamic finance principles.

## OBJECTIVES

At the end of this unit, you will be able to:

i. Gain a comprehensive understanding of financial markets, including their types and the functions of the Islamic financial markets.

ii. Explore the concept, characteristics, functions, participants, and instruments of the Islamic Money Market, discerning its unique features in comparison to conventional money markets.

iii. Understand the Islamic Capital Market, its definition, distinctive characteristics, essential functions, significance, participant roles, and array of instruments, while contrasting it with conventional capital markets.

## 6.1 Sectors of Economy

Economists often divide the overall economy into two sectors i.e. real sector and the financial sector.

**i. Real Sector**

The real sector of the economy produces the nation's output of goods and services.

**ii. Financial Sector/Financial system**

The financial sector plays the vital role of providing the financing needed to fund the productive capacity of the real sector. The financial system does this by mobilising the savings of the surplus units and channelling them to the productive units that need the funds. This means that in a financial system, funds flow between the surplus unit (those entities that have surplus funds but do not have the productive use of those funds), and the deficit units (entities that do not have surplus funds but know the productive use of funds).

## 6.2 Flow of Funds in the Financial System

In the financial system, the funds flow between the borrowers and the lenders through two channels i.e. direct finance and indirect finance.

**i. Direct Finance**

The first channel through which the funds flow directly between the borrowers and lenders is known as direct finance. In direct finance, the funds flow between the two parties through the exchange of finance instruments in the financial markets. A financial market is a place where the surplus units and the deficit units meet directly to exchange funds through the exchange of financial instruments such as the bond market, equity market, money market, and capital markets.

**ii. Indirect Finance**

The second channel through which the funds flow between the borrowers and lenders is known as indirect finance. In indirect finance, the flow of funds between the surplus units and the deficit units is channelled through intermediaries known as financial institutions or financial intermediaries. Financial intermediaries obtain funds from the depositor and transfer those funds to the borrowers. The most important examples of financial institutions are Islamic banks, conventional banks, insurance companies, mutual funds, pension and retirement funds.

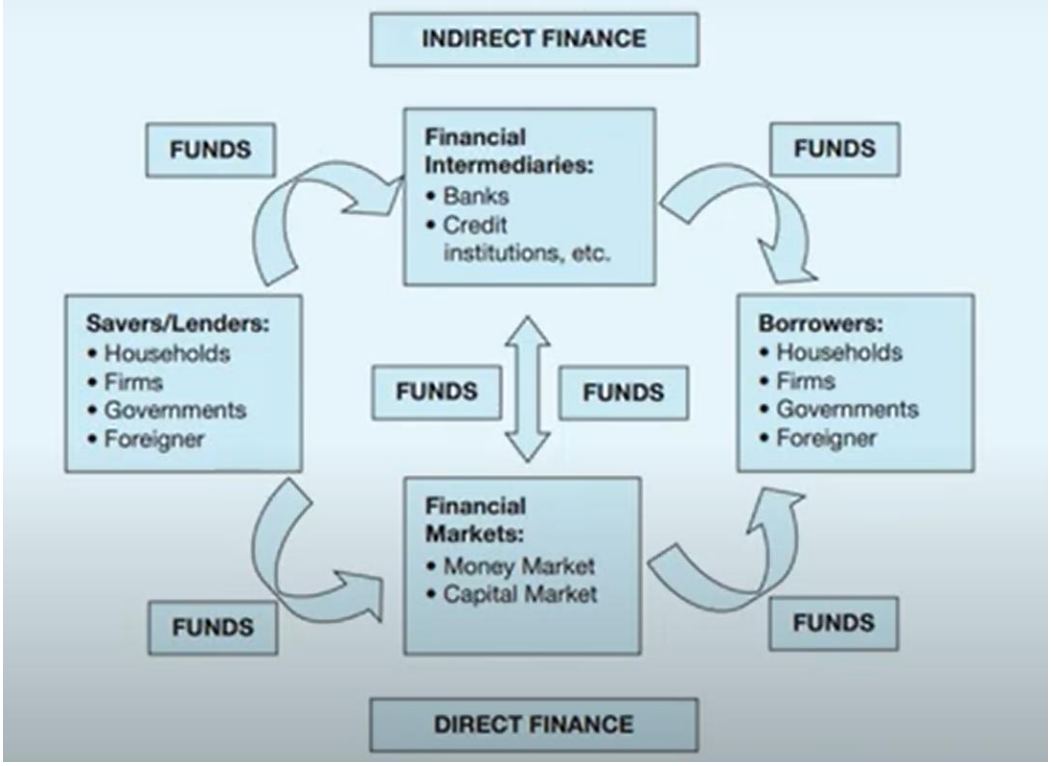



**Figure 6.1: Flow of the funds in the financial system**
**Source: Google**

## 6.3 What are Financial Markets

Financial markets are referred to as any marketplace where securities or financial instruments are issued and traded such as the stock market, bond market, forex market, and derivatives market. A financial instrument is a legal document or a piece of paper that represents a financial asset to one party and a financial liability or equity instrument to another party e.g. share, or bond. Financial instruments are always issued by the deficit units and always purchased by the entity having the surplus funds.

## 6.4 Types of Financial Markets

Financial Markets are categorized into two types based on the maturity of the instrument.

**i. Money Market**

Money Market is the market where the instruments with the maturity of less than one year are issued and traded. It is the market for short-term instruments e.g. T-Bills, certificate of deposits and commercial papers.

**ii. Capital Market**

Capital Market is the market where the instruments with the maturity greater than one year are issued and traded. It is the market for the medium-term (1 to 10 years) and long-term (more than 10 years) instruments e.g. Stocks and Bonds. Capital markets are venues for buying and selling equity securities (such as shares) and debt securities (such as bonds). Capital markets is further divided into primary markets, where new stocks and bonds are issued and sold to investors, and secondary markets, where existing securities are traded.

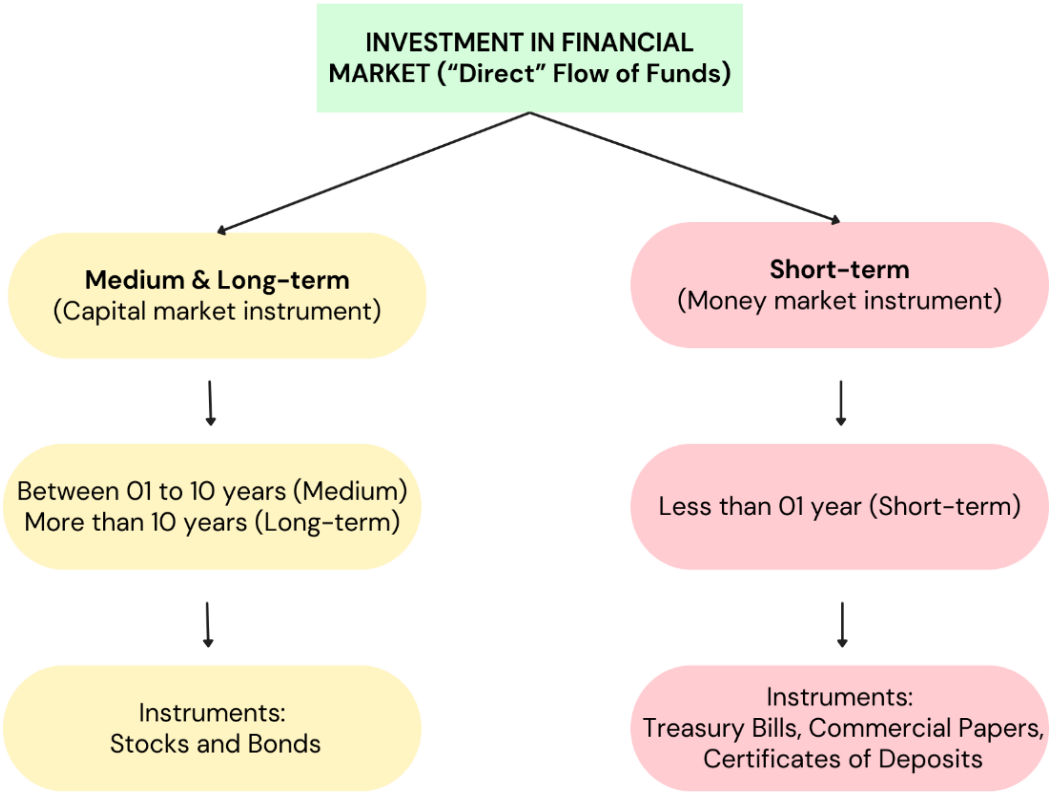



**Figure 6.2: Type of Financial Markets**
**Source: Google**

Similarly, in the context of Islamic finance, they will be regarded as Islamic money markets and Islamic capital markets respectively.

### 6.4.1 Link between Islamic Financial Institutions and Islamic Financial Markets

The connection between Islamic financial institutions and Islamic financial markets is crucial for facilitating the flow of funds within an economy. Financial markets play a vital role in supporting the operations of financial institutions by aiding in

liquidity risk management and fulfilling treasury needs. Additionally, financial markets assist financial institutions in raising capital and determining prices. This relationship ensures efficient resource allocation and supports economic growth in Islamic finance systems.

## 6.5 Islamic Financial Markets

In the Islamic financial market, the funds are exchanged through the issuance of Islamic financial instruments. All the exchange is strictly in adherence to the principles of Shariah.

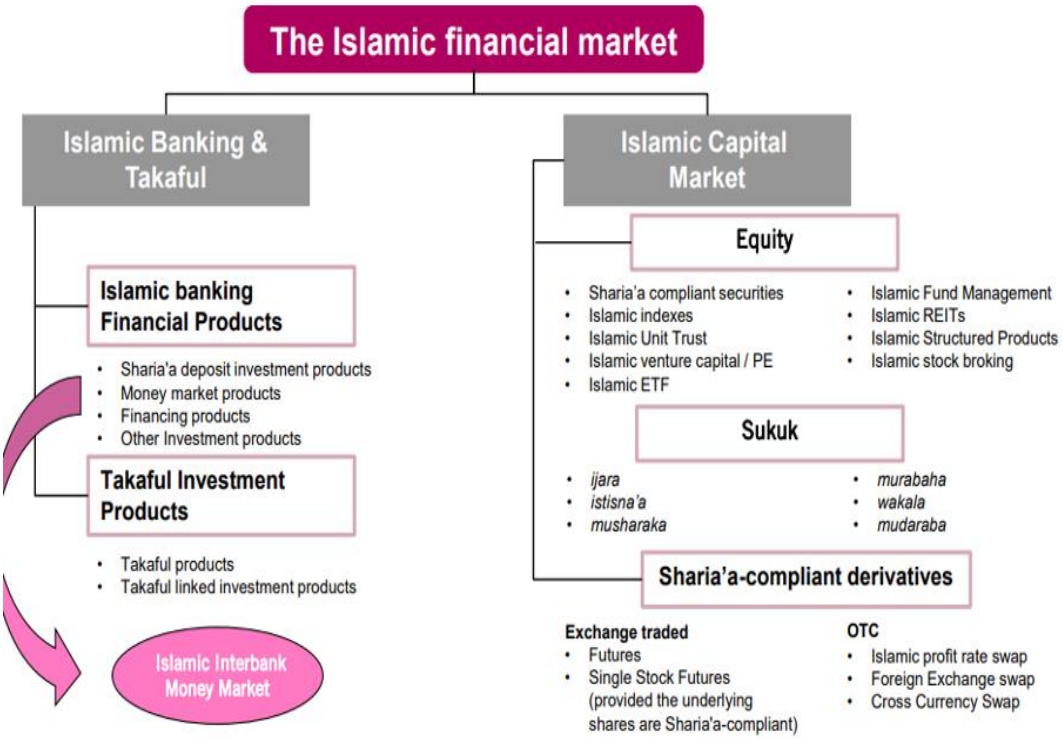



**Figure 6.3: Islamic Financial Market**
**Source: Google**

### 6.5.1 Islamic Money Market

The Islamic money market is the key component of the Islamic financial system. The Islamic money market is the marketplace where short-term Sharia-compliant financial instruments are traded. The transactions in the Islamic money market adhere to the Sharia principles and the activities which involve payment or receipt of interest (Ribah), speculative transactions (Maysir), and uncertainty or ambiguity (Gharar) are strictly prohibited.

**(a) Characteristics of Islamic Money Market**

The Islamic money market is unique in its nature as compared to the conventional money market and possesses the following characteristics.

**i. Large Value transactions**

The volume in the Islamic money market consists of a large value of transactions.

ii. **Short-term instruments**

The instruments traded in the Islamic money market have a maturity of less than one year. It includes securities such as such as Islamic commercial papers, Islamic certificates of deposit, and other short-term investment tools. Islamic money market securities are more liquid and widely traded than longer-term securities.

**iii. Shariah compliance**

The instruments transacted in the Islamic money market are Shariah-compliant.

**iv. Profit and loss sharing**

Islamic money market instruments are structured in compliance with the principles of profit-and-loss sharing. Returns in Islamic money market instruments are generated through a profit-sharing arrangement where both parties share the profits and the losses.

**(b) Functions of Islamic Money Market**

Islamic Monet Market plays a very important role in the financial system. The functions of the Islamic money market include.

**i. Short-term Funds requirements:**

The most important function of the Islamic money market is to facilitate the flow of investable funds from those who have surplus funds to entities in need of funds to meet short-term funds requirements.

**ii. Liquidity management**

The Islamic money market enables Islamic banks to

a. Meet daily funding requirements.
b. Invest in short-term and highly liquid instruments.
c. Helps them to maintain optimal liquidity level (not overly liquid, not illiquid) to meet investors' /customers' demands on time.
d. Enable Islamic banks to manage assets liability mismatch (manage timings of cash inflows and outflows)
e. Provides a means of raising funds by converting securities and financial assets into cash.

**iii. Islamic Interbank money market**

The Islamic money market enables Islamic banks to fund and adjust their portfolios in the short term.

**iv. Investment opportunities:**

The Islamic money market provides opportunities for the investment of surplus funds in various Sariah compliant instruments. It is also used by investors as an interim investment placement that provides a higher return than holding cash.

**v. Working capital:**

Provide a facility to meet the working capital requirement for businesses and to provide the government with short-term funds. It also provides short-term working capital financing for importers and exporters such as Islamic accepted bills.

**vi. Monetary Policy**

The Islamic money market helps central banks to implement monetary policy.

**(c) Participants of Islamic Money Market**

The participants of the Islamic money market include

**i. The Central Bank**

Central banks in countries with Islamic financial systems play a very important role in the management and regulation of the Islamic money market. Central banks, by issuing Islamic financial instruments help manage the liquidity of the participants. Central banks also use the Islamic money market to implement monetary policies following Shariah principles.

**ii. Islamic Financial Institutions**

Islamic financial Institutions such as Islamic banks, Islamic insurance companies (Takaful), Islamic pension and retirement companies, and Islamic mutual funds, participate in the Islamic money market by investing their funds in Shariah-compliant short-term instruments.

**iii. Government entities**

Governments may issue Islamic money market instruments as a means of short-term financing. These instruments comply with Shariah principles and provide an alternative to conventional treasury bills.

**iv. Corporate entities**

Businesses and corporate entities participate in the Islamic money market to manage their short-term funding needs. Corporations may issue or invest in Shariah-compliant instruments to meet their working capital requirements.

**(d) Components of the Islamic Money Market**

The Islamic money market has two main components

***Interbank Deposit System***

The Islamic interbank money market provides a facility to the Islamic banks to manage their liquidity requirements using Sharia-compliant transactions. In an interbank market, banks can access funds at a lower cost compared to other sources. In this market, banks engage in borrowing and lending transactions to obtain funds. They can secure relatively inexpensive short-term funds, typically ranging from overnight to one year, from other participants in the interbank market whenever they have a deficit or need to cover short positions.

These transactions may include Mudarabah deposits, overnight transactions, and other profit-sharing arrangements. e.g. under Mudarabah interbank investment

arrangements, the bank with the deficit funds can obtain funds from the bank with surplus funds based on the Mudarabah contract. The period of investment is from overnight to 12 months. The profit sharing ratio is pre-determined and negotiated between both parties while losses are borne by the investor. On the maturity date, the principal plus profit is paid by the investor.

***Money Market Instrument***

i. **Islamic Certificates of Deposit (ICDs):**
   Islamic certificate of deposits is the short-term deposits maintained by Islamic banks for a specified maturity date. The return to the depositors is based on the profits generated from the use of the funds.

ii. **Islamic Commercial Papers (ICPs):**
   Islamic commercial papers are the instruments issued by corporations or financial institutions to funds with maturity for a period of up to one year. The corporation issues the certificates, and the return is provided to the investor based on profit and loss sharing. This instrument is designed to meet the short-term needs of businesses.

iii. **Wadiah Acceptance**
   Wadiah's acceptance is the arrangement between the central bank and the Islamic banks. In this arrangement, Islamic banks place their surplus funds with the central bank on an overnight basis using the concept of Al-Wadiah. Under the Wadiah contract, the central bank the custodian of the funds is not obliged to pay any return on these accounts. Any return paid by the custodian is considered as Hibah. Wadiah acceptance also operates based on Amanah, and Qard Hassana.

iv. **Wakala Certificates:**
   Wakala agreements refer to an agency agreement where one party acts as an agent for another. Wakala certificates involve an investment agency arrangement, where the investor appoints an agent to invest funds on a short-term basis on behalf of the investor, and profits are shared based on a pre-agreed ratio.

v. **Islamic Treasury Bills (ITBs):**
   Islamic treasury bills are short-term securities issued by government securities with a maturity of less than one year to meet their funds requirements. Investors' return is based on profit and loss sharing. The principal amount is repaid at maturity. ITBs' are considered to be low-risk securities due to sovereign guarantees by the government.

vi. **Islamic accepted bill** (IAB)
   Islamic accepted bill is an Islamic money market instrument to facilitate domestic and foreign trade using an Islamic financing instrument. IAB is developed on the principles of Al-Murabahah and Bai Al-dayn. It is a bill of

exchange drawn by the purchaser's bank and accepted by the purchaser which creates a debt owing to the bank. The bank may sell the IAB in the secondary market at a discount value under the Bay al-dayn concept. Murabahah is the selling of merchandise at a price based on a cost-plus profit margin agreed to by both parties (importer/exporter with banks) and Bai al-dayn refers to the sale of a debt arising from a trade transaction in the form of a deferred payment sale.

**vii. Tawarruq (Commodity Murabahah):**

Tawarruq or commodity Murabahah is a contract that consists of a series of buy and sell transactions of commodities to meet the liquidity requirements of the parties involved. The underlying asset in such a contract includes commodities such as copper, aluminium, lead, palm oil, or crude oil. One bank buys the commodity at the spot price from the supplier and sells the commodity to another bank on a deferred-payment basis (for three months), at the spot price plus a profit margin. The bank that buys the commodity on a deferred basis immediately sells it to a broker or another institution at the spot price. The first bank makes a profit from the markup in the transaction, and the second bank raises funds it can use immediately for investment. This financing structure is considered Shariah-compliant because the bank's markup is considered profit rather than interest.

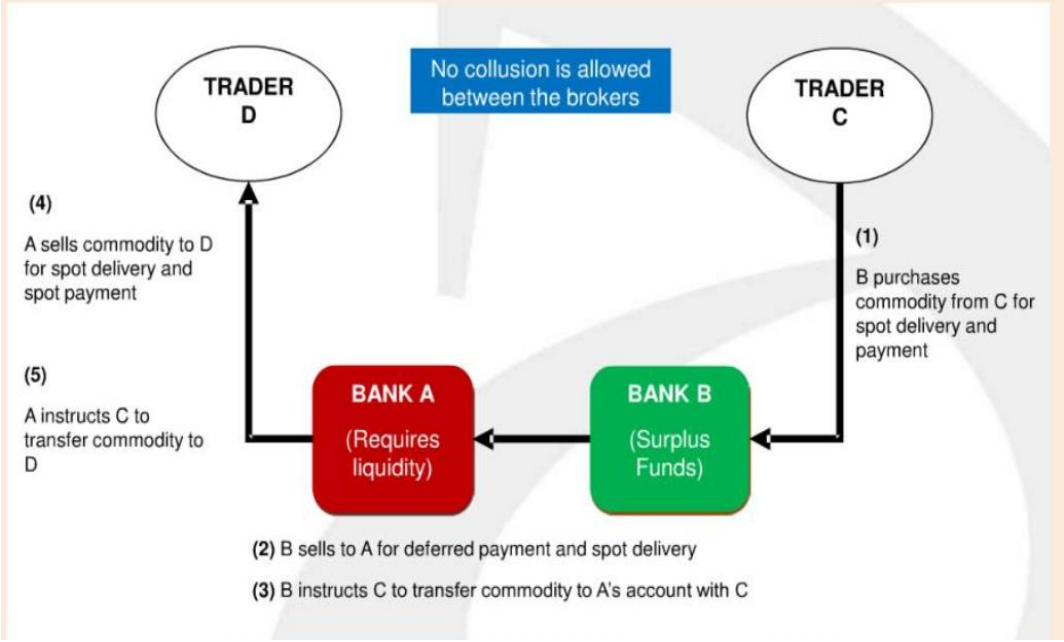



**Figure 6.4: Commodity Murabahah**
**Source: Google**

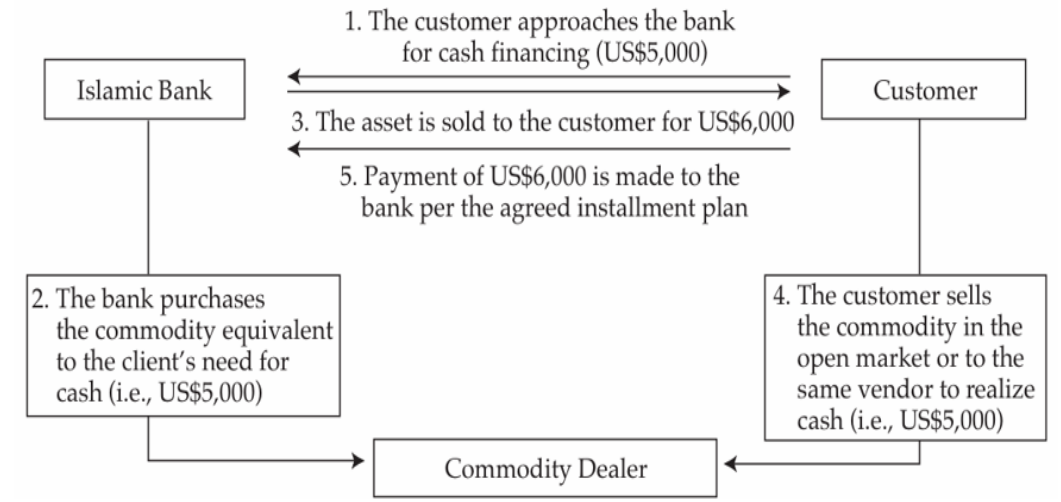



**Figure 6.5: Structure of Tawarruq Financing**
**Source: Book: A Primer on Islamic Finance**

### 6.5.2 Islamic Capital Market

The Islamic capital market is the marketplace where medium-term and long-term Sharia-compliant financial instruments are issued and traded. The Islamic Capital market facilitates transactions involving Shariah-compliant financial assets such as Islamic bonds/Sukuk and Shari'ah Compliant stocks. Islamic capital market serves the purpose of meeting the long-term funds needs of the investors seeking shariah-based returns. Companies and governments utilize Islamic Capital Markets to raise funds for their operations or to expand their activities. For instance, a company might conduct an IPO, while a government may issue Shariah-compliant securities or Sukuk to finance public projects.

#### (a) Characteristics of Islamic Capital Market

Following are the characteristics of the Islamic capital market that distinguish it from the conventional capital market.

i. Sharia Compliance
ii. Interest-Free Transactions
iii. Asset-backed financing
iv. Profit-and-Loss Sharing

## (b) Functions of Islamic Capital Market

Islamic capital markets play very important role in the economy which are explained as follows;

**i. Potential for higher returns**

Islamic capital market provides investors with the potential to get higher returns. Investors are available with a range of investment products that are consistent with Islamic principles, such as Sukuk and Islamic equities.

**ii. Source of long-term financing**

Islamic capital market provides a source of long-term financing for businesses and the Government. The Islamic Capital Market relies on Shariah principes of risk and return sharing which provide a more equitable distribution of risk and return between issuers and investors. This helps companies fund their expansion and development projects.

**iii. Investment opportunities**

The Islamic Capital Market enables investors to invest their capital in a manner that is consistent with their religious beliefs. The Islamic Capital Market also offers a range of investment products, such as Sukuk, Islamic equities, and Islamic funds, which provide investors with a diversified portfolio that is consistent with Islamic principles.

**iv. Wealth redistribution**

Islamic capital market encourages redistribution of wealth through profit and loss sharing mechanisms. Investors share in the profits generated by the underlying assets or projects.

**v. Assets-backed arrangements.**

Islamic capital market instruments are often backed by tangible assets or services, ensuring that financial transactions are linked to real economic activities and assets.

**vi. Contribution into real economic activity.**

The Islamic capital market through investment in real assets promotes economic development and infrastructure development.

**vii. Cross-Border Listings**

Islamic capital market instruments may be listed on international exchanges, allowing for cross-border investments, and increasing the visibility of Islamic finance in the global financial system.

## (c) Participants of Islamic Capital Market

Participants in the Islamic capital market are the entities that are involved in issuance, trading and investment in Shariah-compliant capital market instruments. Key participants in the Islamic Capital market include.

**i. Issuers:**

Issuers are the entities which in need of funds to finance their operations in compliance with Sharia principles such as corporations, governments, and Islamic financial institutions.

**ii. Investors:**

Investors are Individuals Institutions and government entities who provide funds to the issuers by investing in Shariah-compliant capital market instruments.

**iii. Islamic financial institutions:**

Islamic financial institutions facilitate transactions between issuers and investors in the Islamic Capital Market by providing financial services and managing funds. It includes investment banks, asset management firms, and brokerage firms.

**iv. Regulatory Authorities:**

Regulatory authorities oversee and regulate the Islamic capital market to ensure compliance with Sharia principles and financial regulations. It includes the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

**v. Sharia Advisory Board**

Sharia scholars and boards ensure that financial instruments and transactions comply with Islamic principles. Approval of the Shariah advisory board is required for the issuance and trading of Islamic securities.

**vi. Rating Agencies:**

Rating agencies provide assessments of the creditworthiness of the issuers of capital market instruments.

**vii. Investment Funds:**

Islamic investment funds pool funds from investors and invest in a diversified portfolio of Sharia-compliant assets, including Islamic securities traded in the capital market.

### (d) Instruments of Islamic Capital Market

Islamic capital market instruments enable financial activity without disobeying Shariah, and they include.

***Islamic Equities (Sharia-Compliant Stocks)***

Islamic equities are Sharia-compliant stocks which represent ownership in companies that operate following Islamic principles. Islamic equities are the same as common stocks or shares which represent the basic voting shares within a company or corporation. The holder of an ordinary share is usually entitled to one vote per share. Money raised from issuing Islamic equities is invested in Shariah-based products. It excludes companies engaged in activities such as gambling, alcohol, or interest-based financing.

***Islamic Investment Funds***

Islamic investment funds are the mutual funds which invest in Sharia-compliant products which include sukuk, and equities.

***Sukuk (Islamic Bonds)***

Sukuk is a plural of the word "Suuk" means "Papers". These papers are used to represent financial obligations, originating from trade and other commercial activities. Sukuk are Islamic bonds, serving as the Sharia-compliant counterpart to conventional bonds.

Sukuk are the asset-based financial instruments issued for raising capital according to Sharia principles. Sukuk is a capital market instrument in which the ownership of the underlying asset is transferred to a large number of investors through certificates. These certificates are called Sukuk. Sukuk represents the undivided share of ownership in an asset or a pool of assets. Investors receive periodic returns based on the profits generated by the underlying assets. Sukuks can be issued in tradeable form and listed on usual stock exchanges. In Sukuk, investors do not simply have a claim in cash flow, but an ownership claim in a pool of assets

Following are different types of sukuk based on Islami banking instruments.

i. Mudarabah Sukuk
ii. Murabaha Sukuk
iii. Ijarah Sukuk
iv. Salam Sukuk
v. Musharakah Sukuk
vi. Diminishing-Musharakah Sukuk

***Sukuk Certificates Issuance Process***

The distinctive nature of Sukuk necessitates a specialized issuing process for this financial instrument. The following steps are typically involved in the issuance process.

i. A company needing capital, known as the "originator," creates a Special Purpose Vehicle (SPV). An SPV is a separate legal entity with its assets, liabilities, and legal status, typically established to isolate financial risk. This ensures that if the parent company goes bankrupt, the SPV can continue to operate independently.
ii. The SPV issues Sukuk certificates which are sold to investors.
iii. Using the proceeds from the sale of these certificates, the originator purchases the underlying asset.
iv. The SPV purchases the asset from the originator.
v. The SPV pays the originator the proceeds from the asset sale.
vi. The SPV leases the asset back to the originator, who makes lease payments to the SPV. These payments are subsequently distributed among the certificate holders as lease income.

vii. At the end of the lease term, the originator repurchases the asset from the SPV at its nominal value, and the proceeds are distributed to the certificate holders by SPV.

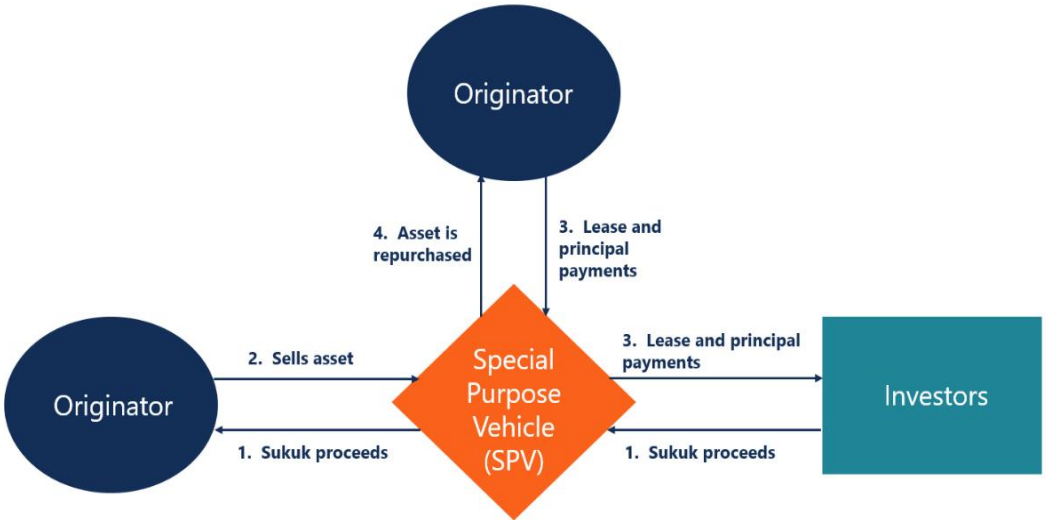



**Figure 6.6: Sukkuk Issuance Process**
**Source: Google**

***What are Conventional Bonds?***

A bond is a conventional debt security issued by a borrower corporation or Government, wherein the borrower promises to repay the holder/investor the amount borrowed in the form of periodic interest payments for specific periods along with the face value at the end of the period.

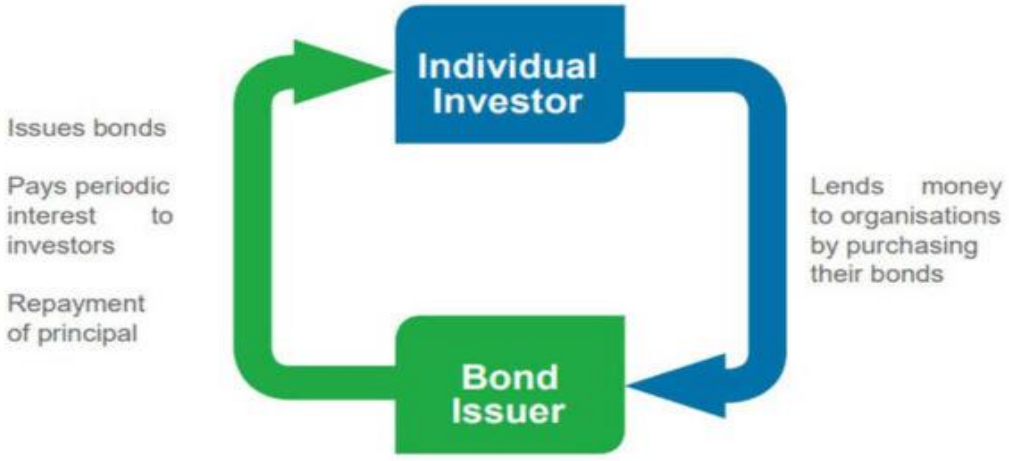



**Figure 6.7: Conventional Bonds Issuance**
**Source: Google**

**Table 6.1: Difference between Sukkuk and Conventional Bonds**

| | **Sukuk** | **Conventional Bond** |
|---|---|---|
| Issuer | The issuer of Sukuk must be involved in business activities that comply with Shari'ah principles. | "The issuer of conventional bonds faces no restrictions on its business activities. |
| Investor base | Attracts a broad range of investors, including both Islamic and conventional investors. | Conventional bonds primarily attract investors from the conventional market. |
| Ownership | Investors acquire ownership of an underlying asset or a pool of asset | A conventional bond represents the financial liability (debt) of the issuer |
| Administrative costs | Additional legal fees and Shari'ah advisory fees may apply | There are no extra administrative costs linked to a conventional issue. |
| Financing costs | A broader investor base can generate greater demand and contribute to achieving more competitive pricing. | A smaller group of conventional bond investors may result in lower demand for the instrument comparatively. |

## 6.6 Difference between Islamic & Conventional Financial Markets

The Islamic financial markets differ from the conventional markets in several ways.

**i. Basis of Transactions:**
Islamic financial markets operate on Shariah principles which prohibit transactions involving interest (Riba), and uncertainty (Gharar) whereas conventional Capital Market involves interest-bearing instruments like conventional bonds and loans.

**ii. Interest (Riba):**
Instruments in Islamic financial markets are non-interest based whereas interest is the fundamental component of conventional financial markets.

**iii. Asset-Backed Financing:**
Islamic financial markets involve products backed by real assets. The concept of leveraging against assets is permissible whereas in Conventional markets the transactions are not always backed by real assets.

**iv. Risk and Profit-and-Loss Sharing:**
Islamic markets employ instruments such as Mudarabah and Musharakah which are based on risk and profit-and-loss sharing. Conventional Capital Market, on the other hand, involves fixed returns on investments, and losses are borne by the investor.

v. **Islamic Financial Instruments:**
Islamic financial markets utilize Shariah-compliant financial instruments, such as Sukuk (Islamic bonds), Islamic mutual funds, and Islamic equity investments. Whereas conventional markets involve instruments such as bonds, stocks, derivatives, and traditional banking products.

vi. **Ethical Considerations:**
Islamic financial markets promote ethical and moral principles and avoid investments in gambling, alcohol, pork, and other activities prohibited by Shariah. Conventional markets, on the other hand, may involve investments which do not align with ethical or socially responsible criteria.

## SUMMARY

This unit introduces students to the concept of Islamic financial markets. It provides an understanding of the basics of financial markets, which is a place where money and assets are bought and sold. It focuses on the Islamic Money Market, which is where short-term financial deals happen in line with Islamic principles. It also discusses its key features, how it works, and who's involved. After that, we'll move on to the Islamic Capital Market, where longer-term investments are made in a way that follows Islamic rules. A comparison of Islamic markets with conventional markets is also provided to see what makes it different.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
   i. What is the financial market?
   ii. What is the Islamic money market?
   iii. What is the interbank money market?
   iv. What is the Islamic capital market?
   v. What are the participants of the Islamic money market?

2. Write long notes on the following questions.
   i. Write notes on Instruments of the Islamic Capital Market
   ii. Write a note on the Instruments of the Islamic Money Market
   iii. Difference between Islamic and Conventional Financial Markets

3. Please fill in the blank spaces.
   i. The …… is the marketplace where short-term Sharia-compliant financial instruments are traded.
   ii. …… are the instruments issued by corporations or financial institutions to funds with maturity for a period of up to one year.
   iii. ……is a contract that consists of a series of buy and sell transactions of commodities in to meet the liquidity requirements of the parties involved.
   iv. The ……is the marketplace where medium-term and long-term Sharia-compliant financial instruments are traded.
   v. ……are the papers that are used to represent financial obligations, originating from trade and other commercial activities.

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**Unit–7**

# THE REGULATORY AND SHARI'A GOVERNANCE FRAMEWORK FOR ISLAMIC BANKS

**Written by: Dr. Nosheen**

**Reviewed by: Dr. Muhammad Suleman Afzal**

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## INTRODUCTION

This unit examines into the essential regulatory framework governing Islamic banking, shedding light on its historical context, regulatory bodies, Shariah governance, instruments, and the challenges it faces. Islamic banking operates under a unique set of principles and guidelines, necessitating a specialized regulatory framework to ensure compliance and integrity within the industry. This unit aims to provide learners with a comprehensive understanding of the regulatory landscape that governs Islamic banking institutions worldwide.

## OBJECTIVES

At the end of this unit, you will be able to.

i. Explore the concept of Islamic regulatory framework, including its necessity, objectives, and purposes, to comprehend its significance in ensuring adherence to Islamic principles within the banking sector.

ii. Examine the historical context of Islamic banking regulation, tracing its evolution and development over time.

iii. Familiarize with the various regulatory bodies and authorities responsible for overseeing Islamic banking operations.

iv. Explore the regulatory instruments and guidelines used to govern Islamic banking operations.

## 7.1 Regulatory Framework for Islamic Banks

The regulatory framework for Islamic banks aims to monitor and regulate Islamic banks. The regulatory framework provides a set of rules, guidelines, standards, and regulations to govern the operations of Islamic financial institutions and to ensure the adherence of these operations and practices to the Shariah principles.

### 7.1.1 Need for a Regulatory Framework for Islamic Banks

Islamic banking is based on the unique principles of Shariah law. The core principles of Islamic finance include the prohibition of Riba, risk and return sharing, assets-backed financing and ethical financial transactions. Shariah requires all the activities and transactions undertaken by Islamic banking must follow Islamic banking principles. The compliance of Islamic banking activities with the Shariah principles requires the existence of a separate regulatory framework that aims to regulate Islamic banks based on their distinct features and underlying principles. In most countries with the presence of Islamic banks (IBs), the default regulatory framework is provided by the Basel Committee on Banking Supervision (BCBS). However, many jurisdictions enhance this framework by incorporating standards from the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to ensure compliance with Shariah law.

### 7.1.2 Objectives of Establishment of Regulatory Framework for Islamic Banks

The regulatory framework based on the divine principles of Shariah is established to achieve the following two objectives.

i. To ensure financial stability by preserving a sound Islamic financial system
ii. To preserve the sanctity of Shariah conduct

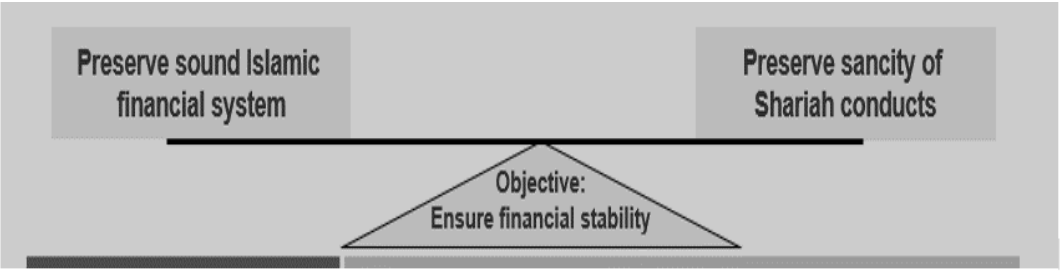



**Figure 7.1: Objectives of Regulatory Framework for Islamic Banks**
**Source: Google**

### 7.1.3 The Purposes of Regulatory Framework for Islamic Banks

The overall purpose of the Islamic regulatory framework is to ensure the growth and sustainability of the Islamic banking sector while keeping adherence to the Shariah principles and ethical standards as the prime goal.

i. **Stability of the financial system**
   The regulatory framework for Islamic banks requires Islamic banks to adhere to the international regulatory and shariah standards and prudential regulations about capital adequacy, liquidity, and risk management which ultimately ensure the soundness of Islamic financial institutions and the overall financial system.

ii. **Shariah compliance**
   The regulatory framework ensures that Islamic banks adhere to Sharia principles, which include the prohibition of Riba (Usury), uncertainty (Gharar) and speculation (Maysir), and adherence to ethical and moral standards.

iii. **Consumer Protection**
   It ensures access to transparent information to the customers. It includes providing disclosure of the rules and regulations, practices and operations of the Islamic institutions and compliance with the Shariah principles.

iv. **Market Integrity**
   Islamic regulatory framework promotes the integrity of the Islamic financial markets by ensuring the application of Islamic ethical and moral standards in letter and spirit and discouraging fraudulent activities.

v. **Standardization and Consistency:**
   The regulatory framework encourages standardization of the practices of Islamic financial institutions to ensure the credibility of Islamic banking transactions and to promote cross-border operations,

vi. **Sharia Supervision:**
   The regulatory framework requires the establishment of Sharia advisory boards to ensure the development of Islamic financial products and instruments fully adheres to Sharia principles.

vii. **Innovation and Product Development:**
   The Islamic regulatory framework aims to promote the development of innovative Islamic financial products, instruments and services by financial institutions that align with Sharia principles.

## 7.2 Historical Context of Islamic Banking Regulation

The need for the Islamic regulatory framework started with the establishment of Islamic banking. The establishment of entities truly designated to regulate and supervise Islamic financial institutions started along with the growth of Islamic banking.

**i. Emergence of Islamic Banking:**

The roots of Islamic banking regulation can be traced back to the 1960s and 1970s when the first modern Islamic banks were established. From the 1970s to the 1980s, financial institutions based on Islamic banking were established across different parts of the world. The establishment of Dubai Islamic in the year 1975 and the Islamic Development Bank in the year 1976 in Saudia Arabia paved the way for the foundation of Islamic banks at the global level. This recognition in the Islamic banking industry increases the demand for Shariah compliant Islamic financial products and instruments. With the increase in the demand for financial services, the need for a regulatory framework to govern Islamic financial transactions and institutions increases.

**ii. Establishment of Regulatory, Supervisory and Standard Setting Bodies:**

In the 1970s and 1980s, countries with significant Islamic banking presence started devising regulations to monitor and oversee Islamic financial institutions and to ensure the adherence of transactions to Sharia principles. In the 1990s and beyond, international standard-setting organizations and accounting and auditing bodies emerged to provide guidelines and standards for Islamic finance. In 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established which developed Shariah, accounting, and auditing standards for the Islamic finance industry globally. In 2003, the Islamic Financial Services Board (IFSB) was established which is an international standard-setting body that devises regulatory and supervisory guidelines for Islamic financial institutions.

**iii. Islamic Regulatory Framework at the National Level**

With the establishment of IFSB and AAOIFI, countries have formulated and devised regulations for Islamic financial institutions at the national level. It includes regulations about the establishment and licensing of full-fledged Islamic financial institutions Islamic banking subsidiaries and Islamic banking divisions/windows of conventional banks. Central banks of the countries having Islamic banking devise clear-cut guidelines for the Islamic banking operations in their jurisdictions.

**iv. Shariah Advisory Boards**

Islamic financial institutions maintain Sharia supervisory boards or advisory boards whose main function is to ensure compliance of Islamic banking practices to the Shariah principle.

## 7.3 Regulatory Bodies and Authorities

The main regulatory bodies and authorities for regulating Islamic financial institutions are as follows.

**i. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)**

AAOIFI was established in the year 1991 in Bahrain. AAOIF is an international corporate body that prepares accounting, auditing, governance, ethics, and Shari'a standards for Islamic financial institutions. Membership of AAIOFI includes Islamic financial institutions, regulatory institutions, and central banks from over 45 countries. The prime purpose of the establishment of AAOIFI is to standardize and harmonize the practices and financial reporting of Islamic financial institutions according to Shariah principles. Moreover, they also provide standards and guidelines to the Islamic financial institutions to boost the growth and prospects of the Islamic banking industry.

**ii. Islamic Financial Services Board (IFSB)**

IFSB was established in 2003 in Malaysia. IFSB is an international standard-setting body that provides global prudential regulations and guiding principles for the regulation and supervision of Islamic financial institutions. Originally it was established to provide supervisory and regulatory services to the central bank and regulators of Islamic banking regulators. However, a few years after their establishment their scope extended to insurance and securities markets. The key functions of IFSB include standard development, guidance and research, coordination with regulatory authorities, policy advocacy, review and assessment, monitoring, and reporting. IFSB ensure transparency of Islamic financial transactions by devising international standards consistent with Shariah principles. IFSB sets standards for Risk management in close collaboration with the Bank for International Settlement (BIS) for Islamic Banks.

**iii. Islamic Development Bank (IDB)**

IDB was established in 1975 in Jeddah, Saudia Arabia. IDB is a multilateral development bank that strives to improve social and economic development in 57 member countries. It aims to influence global Islamic banking development by promoting Shariah-compliant and ethical business activities. Other functions of IDB include providing funds for productive projects and enterprises, providing financial assistance to member countries for social and economic development, promoting trade, supporting capacity building, and technical support among member countries and Promoting skills and knowledge sharing among the member countries.

**iv. International Islamic Financial Market (IIFM)**

IIFM is established in the year 2002 in Bahrain. It is a global standard-setting body for Islamic financial institutions. The prime focus of IIFM is to

standardize and harmonize shariah-compliant financial products and product structures all over the world. It also provides guidelines for Shariah-compliant financial documentation, Islamic financial services industry (IFSI) and product confirmations.

## 7.4 Regulatory Framework for Islamic Banks in Pakistan

The regulatory framework for Islamic banks in Pakistan employs specific policies and guidelines to ensure Shariah compliance. These regulations are issued by the SBP in the form of circulars and circular letters, which serve to issue, update, and amend instructions and guidelines periodically. These guidelines include.

1. Guidelines and criteria for setting up an Islamic banking subsidiary by the existing commercial banks
2. Guidelines and criteria for opening of stand-alone Islamic banking branches by a conventional bank
3. Guidelines and criteria for commencement of Shariah-compliant business and operations by a development finance institution (DFI)
4. Instructions for profit & loss distribution and pool management for Islamic banking institutions
5. Guidelines for Islamic microfinance business by financial institutions
6. Guidelines on Islamic financing for agriculture
7. Risk management guidelines for Islamic banking institutions
8. Policies for promotions of Islamic banking
9. Adoption of 'Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) Shariah Standards
10. Shari'ah Governance Framework (SGF) for Islamic Banking Institutions (IBIs)
11. Enhanced Training & Capacity Building Measures for Islamic Banking Institutions (IBIs)
12. Guidelines for Conversion of a Conventional Bank into an Islamic Bank
13. Criteria For Conversion of Conventional Banking Branches into Islamic Banking Branches
14. Revision of Capital Adequacy Requirement (CAR) For IBB(s)
15. Instructions and Guidelines for Shariah Compliance in Islamic Banking Institutions
16. Shari'ah Non-Compliance Risk Management

## 7.5 Shariah Governance Framework for Islamic Banks

The Shariah governance framework is a system of organizational arrangements that Islamic financial institutions use to ensure effective oversight, responsibility, and accountability among the board of directors, management, and the Shariah committee. It includes guidelines, processes, and structures developed by these

institutions to guarantee that their operations, products, and services comply with Shariah principles. This framework, which sets Islamic banking apart from conventional banking, is designed to instil confidence in the public and financial markets regarding the credibility of Islamic finance operations.

### 7.5.1 Objective of Shariah Governance Framework

The objectives of the Shariah governance framework are to

i. Provide a system and structure to govern all the activities of the Islamic financial institutions to ensure Shari'ah compliance in all the transactions at all levels.
ii. Enable Islamic financial institutions to be recognized and acknowledged as Shari'ah compliant by the stakeholders, including the public.
iii. Ensure operations and processes of Islamic financial institutions are fair and transparent.
iv. Ensure timely disclosure of accurate information and Shariah status of the products of Islamic financial institutions by comprehensive documentation of Shariah board meetings, rulings and compliance reports.
v. Minimize Shariah-related disputes and promote harmony regarding shariah compliance.

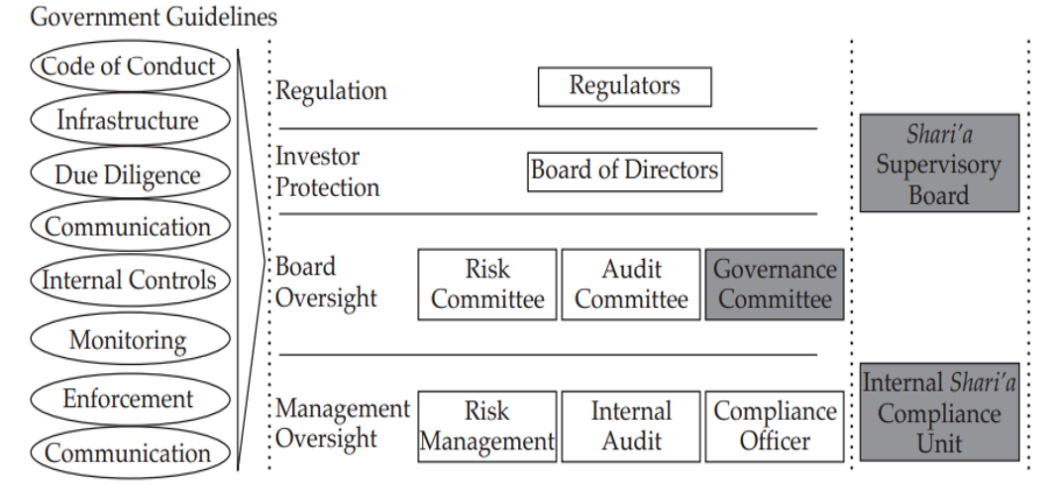



**Figure 7.3: Governance Structure for an Islamic Financial Institution**
**Source: Stanley (2008)**

### 7.5.2 Key Components of Shariah Governance

Shariah Governance framework consists of the following two main components at the regulatory and supervisory authority level and the Islamic financial institutional level.

i. Central Shari'ah Board

ii. Institutional Shari'ah Governance Framework.

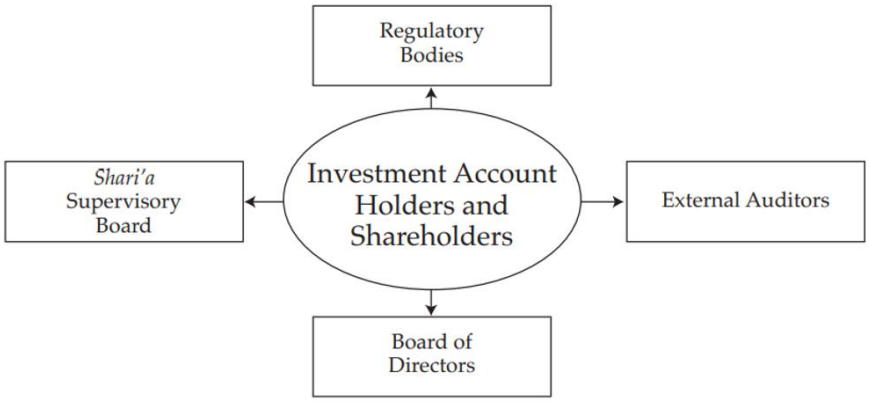



**Figure 7.4 Components of Shari'ah Governance in Islamic Banks**
**Source: Book: A Primer on Islamic Finance**

### (a) Central Shari'ah Board (CSB)

The Central Shariah Board is the Shariah board at the regulatory and supervisory authority level. It is established by the country's central bank. Its purpose is to harmonize Islamic banking and finance practices within the jurisdiction under Shari'ah principles and rules. This board is composed of a diverse group of qualified Shariah scholars, as well as experts in banking, law, and accounting.

***Responsibilities of Central Shari'ah Board***

Central Shari'ah Board performs the following functions.

i. Adoption of AAOIFI Sharī`ah standards and other widely accepted Sharī`ah standards which do not conflict with AAOIFI Sharī`ah standards.
ii. Provision of principles, rulings, guidelines and other functional support to Islamic financial institutions and Regulatory and Supervisory Authority (Central Bank) in their respective jurisdictions.
iii. Advise the central bank in preparing and implementing prudential regulations for Islamic financial institutions.
iv. Advises and to guide the central bank regarding the Shariah compliance and conformity of Islamic financial institutions' products, services, instruments, contracts, and transactions.
v. Advises central banks on Shariah rulings and helps them minimizing shariah-related conflicts that arise due to conflicting Shariah opinions.
vi. Advises central bank regarding the emerging challenges and regulatory requirements due to changing business landscapes.

vii. Provide guidelines for the standardisation of Islamic financial products offered by all Islamic financial institutions e.g. validating product structures and their documentation, services and tools.
viii. Devise a criterion for the appointment of Shariah board members of Islamic financial institutions.
ix. Conduct Shariah audits and reviews to assess Islamic financial institutions ongoing compliance.
x. Issuing fatwas and decisions about its area of work e.g. approving sukuk structures and documentation for sovereign and government sukuk.
xi. Settling any difference of opinion or disagreement between the Islamic financial institution and the regulator, supervising and guiding the Sharī`ah compliance inspection and surveillance of the regulator.

**(b) Institutional Shari'ah Governance Framework**

Islamic financial institution needs to have a basic Shariah Governance Framework at the institutional level that includes the following key components:

**i. Shariah Supervisory Board (SSB)**

An Islamic financial institution (IIFS) must establish an independent, competent, empowered, and adequately resourced Shariah Supervisory Board (SSB). This board should consist of Shariah scholars who are professionally engaged by the IIFS to offer guidance and oversight providing Shariah rulings on products, transactions, and operations. SSB consists of at least three Shariah scholars specialized in fiqh al-muamalat (Islamic commercial jurisprudence).

**ii. Shariah Compliance Function**

The Shariah compliance function ensures that an Islamic financial institution's (IIFS) financial arrangements, contracts, and transactions adhere to Shariah principles and rules. As a key component of an IIFS's governance and control structure, it supports management in maintaining Shariah compliance across all business activities, operations, and transactions daily. The Shariah compliance function involves implementing mechanisms, controls, and processes, and establishing a Shariah compliance department (SCD). It is an ongoing process that continuously monitors the IIFS's overall activities and Shariah compliance environment.

**iii. Internal Shariah Audit Function**

The internal Shariah audit function is a crucial governance component of an IIFS, operating independently of management. Its main goal is to assure the board of directors and the Shariah Supervisory Board (SSB) that the IIFS complies with Shariah principles and rules. The internal Shariah audit evaluates the adequacy and effectiveness of controls designed to ensure adherence to Shariah guidelines.

**iv. Independent External Shariah Audit**

The Independent External Shariah Audit (IESA) offers an unbiased third-party assurance to the stakeholders of an Islamic financial institution (IIFS) regarding its compliance with Shariah principles and rules. IESA has become a global best practice and is increasingly viewed as crucial for maintaining the integrity, reputation, and sustainability of IIFS, particularly those identified as public interest entities, such as retail banks and takaful companies.

***Responsibilities of Institutional Shari'ah Governance Framework***

i. The SSB shall issue Sharī'ah rulings which shall be binding on the IIFS.
ii. The basic responsibility of the board is to ensure strict Shariah compliance of all the products and instruments of the Islamic financial institution.
iii. They provide religious oversight and issue rulings (fatwas) on the permissibility of financial activities.
iv. Provide Shariah guidance regarding the development of new products by assessing the product's structure, terms, and overall compliance with Islamic principles.
v. To ensure that day-to-day operations and transactions comply with Shariah principles.
vi. Oversees and coordinates all aspects of Shariah governance to ensure that the Islamic financial institution's policies, practices, and procedures align with Shariah principles.
vii. Periodic Shariah audits and reviews are conducted to assess the ongoing compliance of the financial institution with Shariah principles.
viii. Educate employees, especially those involved in designing, marketing, and executing financial products regarding Shariah principles.
ix. Ensure ethical and religious considerations in the operations and transactions of Islamic financial institutions.

## 7.6 Shari'ah Governance Framework of Islamic Banking in Pakistan

The Shari'ah governance framework for Islamic banking in Pakistan is supervised and administered primarily by the State Bank of Pakistan (SBP). The SBP issues specific regulations and guidelines governing Islamic banking operations to ensure that Islamic financial institutions operate prudently, manage risks effectively, and maintain financial soundness. Pakistan's Islamic banking regulatory and supervisory framework aligns with international standards and best practices prescribed by standard-setting bodies such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This alignment facilitates cross-border transactions,

enhances credibility, and promotes the integration of Pakistan's Islamic banking sector with global Islamic finance markets.

The primary objective of the Shariah Governance Framework (SGF) is to strengthen the overall Shari'ah compliance environment of Islamic banking institutions and explicitly define the roles and responsibilities of various organs of Islamic banks including the Board of Directors (BOD), Executive Management (EM), Shari'ah Board (SB), Shari'ah Compliance Department (SCD), Product Development (PD), Internal auditors and External auditors towards Shari'ah compliance.

The Shariah Governance Framework for Islamic banks operate at two levels i.e.

i. Central Shari'ah Advisory Committee in SBP
ii. Shariah Governance framework at the Islamic financial institutions level

### 7.6.1 SBP Shari'ah Advisory Committee (SAC)

The Shari'ah Advisory Committee (SAC) of the State Bank of Pakistan (SBP) is an apex body which provides Shari'ah opinion and advice on Shari'ah-related matters. The Shari'ah Advisory Committee comprises Shariah scholars selected from among experts in Islamic jurisprudence, alongside technical members such as accountants, lawyers, senior officials from the State Bank of Pakistan, and specialists from other fields like Economics or Banking & Finance, possessing a strong understanding of Islamic finance principles and practices.

i. The SAC is responsible for regulating and supervising Islamic banks, Islamic banking windows of conventional banks, and other Islamic financial institutions in Pakistan.
ii. Formulates policies, issues regulations, and guides to ensure compliance with Shariah principles and prudential standards.
iii. Conducts inspections, audits, and assessments to monitor the performance and compliance of Islamic banks and financial institutions.
iv. Serves as the highest authority providing guidance and advice on Shariah-related issues.
v. Guides the State Bank of Pakistan regarding the development of prudential regulations tailored for the Islamic banking sector.

### 7.6.2 Shari'ah Governance Framework at Islamic Financial Institutions Level

#### (a) Role of Board of Directors (BOD)

According to the Shariah Governance Framework of the State Bank of Pakistan (SBP), the Board of Directors (BOD) holds ultimate responsibility and accountability for ensuring that the operations of the Islamic Banking Institution fully comply with Shariah principles.

i. The BOD must appoint a Shariah Board (SB) to establish and implement an effective Shariah compliance framework.
ii. The BOD is also required to introduce a robust mechanism, including diligent oversight, to ensure the proper functioning of this framework and adherence to the fatawa, instructions, and guidelines issued by the Shariah Board.
iii. Additionally, the BOD must meet with the SB at least twice a year to receive a detailed briefing on the Shariah compliance environment, identify any issues or weaknesses, and discuss recommendations for improving the Shariah compliance environment.

**(b) Role of Executive Management (EM)**

The Executive Management (EM) of an Islamic financial institution is responsible for implementing the Shariah Governance Framework.

i. Ensure that procedure manuals, product programs, process flows, and related agreements and contracts, as approved by the Shariah Board (SB), are accessible to and understood by everyone in their respective teams or functional areas.
ii. Accountable and responsible for implementing the decisions, rulings, fatawa, and guidelines issued by the Shariah Board (SB) that pertain to their respective group or functional area.
iii. Responsible for coordinating with the Training Department and the Shariah Compliance Department (CD) to provide adequate training for their team members.

**(c) Shari'ah Board (SB)**

Each Islamic financial institution in Pakistan is required to have a Shariah Board (SB) composed of at least three qualified Shariah scholars appointed by the Board of Directors (BOD). The members of the SB serve a term of three years and are eligible for reappointment.

i. The SB is empowered to consider, decide, and oversee all Shariah-related matters of the institution.
ii. All decisions, rulings, and fatawa issued by the SB are binding on the institution, and the SB is responsible and accountable for all its Shariah-related decisions.
iii. The SB is tasked with developing a comprehensive Shariah compliance framework for all areas of the institution's operations.
iv. The SB advises on the compatibility of financial products, services, and transactions with Shariah principles, ensuring compliance and ethical standards. All products and services offered or launched by the institution must have prior approval from the SB.
v. The SB provides guidance, reviews contracts, and resolves any Shariah-related issues or disputes that may arise.

**(d) Resident Shari'ah Board Member (RSBM)**

The Shariah Board (SB) of an Islamic Banking Institution shall, in consultation with the management, designate one of its members, other than the Chairperson, as the Resident Shariah Board Member (RSBM). The RSBM will oversee the procedures for implementing the SB's resolutions, pronouncements, and fatawa, and provide guidance accordingly. RSBM should be appointed on a full-time basis.

**(e) Shari'ah Compliance Department (SCD)**

Each Islamic Financial Institution must have a Shariah Compliance Department (SCD), which may be led by the Resident Shariah Board Member (RSBM) or a suitably qualified, trained, and experienced officer recommended by the Shariah Board (SB).

i. The SCD must be staffed with dedicated and adequate personnel, as advised by the SB, to effectively fulfil its responsibilities on time.
ii. Additionally, the SCD must include at least one qualified Shariah expert, separate from the RSBM.

**(f) Product Development (PD)**

i. Each Islamic Banking Institution (IBI) must establish a Product Development (PD) Department or Unit, which can either operate within the Business units or as an independent department.
ii. The PD is tasked with researching and developing new and innovative products and services that meet the business requirements of the IBI, considering international developments and practices.

**(g) Internal Shari'ah Audit**

i. Each Islamic Financial Institution must establish an Internal Shariah Audit Unit (ISAU), which can be integrated within the internal audit department or operate independently, based on the size of the IBI.
ii. The staff of the Internal Shariah Audit Unit shall be exclusively dedicated to Shariah audit tasks.

**(h) External Shari'ah Audit**

To conduct an independent assessment of the Shariah governance and compliance practices at an Islamic Financial Institution, the external Shariah audit focuses on verifying the adherence of the institution's financial arrangements, contracts, and transactions to Shariah rules and principles. This includes:

i. Compliance with essential regulations, instructions, and guidelines issued by the State Bank of Pakistan (SBP), which incorporate Shariah standards from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as modified by SBP.

ii. Adherence to rulings issued by the Shariah Advisory Committee of SBP, as communicated by SBP.
iii. Compliance with relevant Islamic Financial Accounting Standards as mandated by the Securities and Exchange Commission of Pakistan (SECP) and disseminated by SBP.
iv. Confirmation of approvals and rulings issued by the Shariah Board (SB) of the IFI, in alignment with SBP directives, regulations, instructions, and guidelines based on the rulings from the Shariah Advisory Committee of SBP.

## SUMMARY

This Unit provides learners with a comprehensive overview of the regulatory framework governing Islamic banking. We begin by understanding the concept and necessity of an Islamic regulatory framework and exploring its objectives and purposes. Subsequently, we delve into the historical context of Islamic banking regulation, tracing its evolution and development. We then discuss the various regulatory bodies and authorities responsible for oversight and compliance. Furthermore, we examine the Shariah governance framework and its pivotal role in ensuring adherence to Islamic principles. This unit provides learners with a profound understanding of the regulatory framework governing Islamic banking, equipping them with essential knowledge for navigating this dynamic sector.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
   i. What is the Islamic regulatory framework?
   ii. What purpose does the Islamic regulatory framework serve?
   iii. Name the Islamic Banking Regulatory bodies.
   iv. What is Shariah Governance?
   v. What is Shariah supervision?

2. Write long notes on the following topics.
   i. Shariah Governance framework
   ii. Regulatory Bodies and Authorities
   iii. Historical Context of Islamic Banking Regulation

3. Please fill in the blank spaces.
   i. The Islamic regulatory framework is a regulatory framework established to ……. Islamic banks
   ii. Islamic Financial Services Board (IFSB) was established in ……..
   iii. AAOIFI was established in 1991 in ……
   iv. …… is a multilateral development bank striving to improve social and economic development in 57 member countries
   v. ……. refers to the guidelines, processes and structure devised by Islamic financial institutions to ensure that their operations, products, and services comply with the Shariah principles.

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**Unit–8**

# PRESENT STATUS OF ISLAMIC BANKING IN PAKISTAN

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**Reviewed by: Dr. Muhammad Suleman Afzal**

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# INTRODUCTION

The development and evolution of Islamic banking in Pakistan have been significant in recent years, with the country witnessing a surge in the establishment of Islamic banking institutions. This chapter aims to provide a comprehensive overview of the present status of Islamic banking in Pakistan, shedding light on its historical context, the current landscape of Islamic banking institutions, their performance, and a comparative analysis with Islamic banking systems across the globe.

# OBJECTIVES

At the end of this unit, you will be able to.

i. Explore the historical context of Islamic banking in Pakistan, tracing its origins and evolution.

ii. Provide an overview of the different types of Islamic banking institutions in Pakistan, including full-fledged Islamic banks, Islamic branches of conventional banks, and Islamic windows of conventional banks.

iii. Analyse the performance of Islamic banking in Pakistan, including key financial indicators.

iv. Examine the performance of Islamic banks globally.

## 8.1 Historical Context of Islamic Banking in Pakistan

Pakistan is an Islamic ideological country and the abolition of usury, and the establishment of Islamic banking are of great importance for the protection of its Islamic ideological boundaries. That is why, immediately after the formation of Pakistan, efforts were made to abolish the Islamic economy and usury. Inaugurating the State Bank of Pakistan on July 1, 1948, Quaid-e-Azam Muhammad Jinnah made it clear that Pakistan's economic and banking system would be structured following the principles of Islam. The constitutions of 1956, 1962 and 1973 clearly state that Pakistan's economy has become interest-free.

### 8.1.1 Phase of Islamic Banking Development in Pakistan

The overall efforts to introduce interest-free banking can be divided into three phases; the first phase starts from 1947 and stretches to the 1960s, the Second from 1960 to 2000, and the last from 2000 onwards.

**First Phase (1947 to 1960)**

The first phase started with the independence of the country in 1947. The founder of Pakistan, at the time of the inauguration of SBP, emphasized the importance of Islamic principles in the economic system of a country. The Government of Pakistan established the Council of Islamic Ideology (CII). Initially, the research on Islamic finance was undertaken by eminent Shariah scholars both from abroad and in Pakistan. An Islamic Economic Division was created in the Research Department of SBP in the 1950s and was entrusted to undertake research on the Islamic economic system and it also as a secretariat to the Council of Islamic Ideology (CII).

**Second Phase (1960 to 2000)**

In the second phase (1960 – 2000), efforts reached their peak and in 1969, the Council of Islamic Ideology (CII) declared the interest-based system against Islam. In the 1980s, CII provided suggestions to make the country’s economy Islamised. In 1991, the Federal Shari’ah Court decided that the time multiple counter loan is Shari’ah non-compliant and advised the Government to do several reforms.

**Third Phase (2000s onwards)**

This point in time became the starting point of the third phase of Islamizing the economy and the financial system. Efforts towards Shariah-compliant banking system in Pakistan were re-launched in 2001-02. The new paradigm was based on a model that allowed Islamic banking to operate in the country as an alternative and parallel system with three types of Islamic banking institutions.

i. Full-fledged Islamic banks,

ii. Islamic banking branches of conventional banks.
iii. Islamic banking windows of conventional banks

Considering Shariah compliance as the most essential element of Islamic banking, the State Bank of Pakistan has put in place a comprehensive and robust multi-tiered Shariah compliance mechanism. The main components of the framework are:

i. Shariah board at the Central Bank,
ii. Shariah board comprising of at least three members at the bank's level,
iii. mandatory internal Shariah audit,
iv. Shariah inspection.

## 8.2 Overview of Islamic Banking Institutions in Pakistan

As of the end of June 2023, the Islamic banking sector in Pakistan consisted of 22 institutions, comprising 6 exclusive Islamic Banks (IBs) and 16 Conventional Banks with dedicated Islamic Banking Branches (IBBs).

### 8.2.1 Full-Fledged Islamic Banks

#### (a) What are Full-Fledge Islamic Banks

Full-fledged Islamic banks are financial institutions that conduct their operations by Islamic principles and adhere to Sharia law in every aspect. These banks offer a diverse range of financial services and products that align with Islamic finance principles, prohibiting the payment or receipt of interest (Riba) while emphasizing ethical and socially responsible investment practices.

#### (b) Full-Fledge Islamic Banks in Pakistan

Presently, Six Islamic banks are operating as full-fledged entities in Pakistan.

***Meezan Bank Pakistan***

**i. Introduction:**

Meezan Bank is the top Islamic bank in Pakistan. It started operating in the country in 2002, making it the first Islamic bank. It's also the largest Islamic bank and is publicly listed, having a paid-up capital of Rs. 17.91 billion. The bank has achieved rapid growth, making it one of the fastest-growing banks in Pakistan's banking history.

**ii. Corporate Governance:**

The leadership of Meezan Bank is overseen by the Board of Directors, headed by Riyadh S.A.A. Edrees as the Chairman. Mr Irfan Siddiqui, the founding president and CEO of Meezan Bank, plays a key role in the governance structure.

**iii. Shariah Supervisory Board:**

Meezan Bank's Shariah Supervisory Board is well-known worldwide. It has

four members, including a chairman, vice-chairman, board member, and a Resident Shariah Board Member. The chairman is Justice (retd) Muhammad Taqi Usmani, and Dr. Mufti Muhammad Imran Ashraf Usmani is the vice chairman.

**iv. Islamic Banking Products:**

Meezan Bank follows Islamic finance principles closely and provides a diverse range of Sharia-compliant financial products and services. These offerings cover personal banking products like Meezan Asan, Meezan Rupee, Meezan Kids Club, and consumer finance. Additionally, the bank extends financing products such as Murabahah, Musawamah, Istisna, and Commodity salam and provides services for small enterprises and corporations, Islamic advisory services, and asset management.

**v. Financial Performance:**

In 2022, the total assets of Meezan Bank stood at Rs 2.5 trillion as compared to Rs 789 billion in 2017. The total deposits also went up a lot, from Rs 667 billion in 2017 to Rs 1.66 trillion in 2022, and the profit after taxation increased seven times, going from Rs 6.3 billion in 2017 to Rs 45 billion in 2022.

**vi. Branch Network:**

Meezan Bank has a strong branch network, strategically placed across Pakistan, including major cities and regions. With a total of 1003 branches, the bank is effectively delivering Islamic banking services to its customers.

***Bank Islami Pakistan Limited***

**i. Introduction:**

Bank Islami Pakistan Limited is the second-largest Islamic bank in Pakistan. Bank Islami Bank started its operation in 2006.

**ii. Corporate Governance:**

The Board of Directors of Bank Islami includes Mr. Ali Hussain who is the Chairman of the board and Mr. Syed Amir Ali who is the President & Chief Executive Officer of Bank Islami.

**iii. Shariah Supervisory Board:**

The Shariah Supervisory Board of Bank Islami consist of four members and is headed by Mufti Irshad Ahmad Aijaz who is the chairperson of the Shariah supervisory board.

**iv. Islamic Banking Products:**

Bank Islami offers Islami Khair account, Islami Sahulat account, Islami Bachat account, auto finance, takaful and mutual funds according to Islamic banking principles. Furthermore, Bank Islami offer services for corporate banking, trade financing services, SME financing and Agri financing services.

**v. Financial Performance:**

The total assets of Bank Islami Pakistani have reached 487 billion rupees with an increase of 195 as compared to the previous year. The total deposits also went up by 21% reaching Rs. 416 billion, and the profit after taxation increased by 108% and now stood at Rs. 4.4 billion in 2022.

**vi. Branch Network:**

Bank Islami has total branches of 347 operating in 141 cities of Pakistan.

**(c) Dubai Islamic Bank Pakistan**

**i. Introduction:**

Dubai Islamic Bank Pakistan Limited (DIBPL) initiated its operations in 2005 as a wholly owned subsidiary of Dubai Islamic Bank UAE, which is the world's first Islamic Bank. The parent institution, Dubai Islamic Bank (DIB), is a leading Islamic financial entity established in 1975 and headquartered in the United Arab Emirates (UAE). DIBL functions as a fully Sharia-compliant bank, providing a diverse array of Islamic banking products and services.

**ii. Corporate Governance:**

DIBP adheres to robust corporate governance principles, ensuring transparency, accountability, and ethical practices in its operations. The board of director consist of Mohamed Saeed Ahmed Abdulla Al Sharif who is the chairman of the board, and Junaid Ahmed the CEO of the DIBP.

**iii. Shariah Supervisory Board:**

DIBP has a distinguished Shariah Supervisory Board consisting of four members. Dr. Sheikh Mohamed Ali Elgari is the chairman of the Shariah Supervisory Board.

**iv. Islamic Banking Products:**

Dubai Islamic Bank provides a comprehensive suite of Sharia-compliant financial products. These may include Islamic savings accounts, Mudarabah and Musharakah financing, and Takaful. The banking services of DIBP have been divided into personal banking, digital banking, priority banking, corporate and SME banking.

**v. Financial Performance:**

The financial performance of DIBP shows that the total assets of Bank Islami Pakistani have reached 445 billion rupees. The total deposits stood at 345 billion, and the profit after taxation was Rs. 4 billion in 2022.

**vi. Branch Network:**

DIB has a well-established branch network, both domestically in the UAE and internationally. In Pakistan, DIBP operates through 210 branches.

**(d) Al-Baraka Bank Pakistan Limited**

**i. Introduction:**

Al Baraka Bank (Pakistan) Limited (ABPL) started its operations on October 30th, 2010, following a merger involving Al Baraka Islamic Bank Pakistan (AIBP), the branch operations of Al Baraka Islamic Bank (AIB) Bahrain, and Emirates Global Islamic Bank (Pakistan). The growth of ABPL was further accelerated in November 2016 by the merger of Burj Bank Limited's banking operations into ABPL.

**ii. Corporate Governance:**

ABPL's board of director consist of Dr. Jehad El-Nakla who is the chairman of the board, and Mr. Muhammad Atif Hanif the CEO of the DIBP.

**iii. Shariah Supervisory Board:**

ABPL Shariah Supervisory Board consists of four members. Sheikh Esam Mohammad Ishaq is the chairman of the Shariah supervisory board.

**iv. Islamic Banking Products:**

Islamic banking products include Checking Accounts, term deposits and Specialized Products such as Al Baraka Tabeer Saving Plan, and Hajj Al Baraka Saving Plan. Other products and services include Al Baraka Carsaaz, Secured Purpose Finance, Al Bait Home Finance and Al Baraka Consumer Business.

**v. Financial Performance:**

ABPL has total assets of 236 billion rupees. The total deposits stood at 185 billion, and the profit after taxation was Rs. 1 billion in 2022.

**vi. Branch Network:**

ABPL has a branch network of almost 164 branches in Pakistan.

**(e) MCB Islamic Bank Limited**

**i. Introduction:**

MCB Islamic Bank Limited, a fully owned subsidiary of MCB Bank Limited, began its operations in 2015. The Islamic banking segment of MCB Bank Ltd., consisting of thirty-four branches, was separated and demerged from MCB Bank Ltd., subsequently transferred to MCB Islamic Bank Ltd. as mandated by legal operations.

**ii. Corporate Governance:**

The board of director consist of Mr. Raza Mansha who is the chairman of the board, and Mr. Zargham Khan Durrani serves as the President and CEO.

**iii. Shariah Supervisory Board:**

The Shariah Supervisory Board of MCB Islamic Bank consists of three members.

Prof. Mufti Munib-Ur-Rehman is the chairman of the Shariah supervisory board.

**iv. Islamic Banking Products:**

Islamic banking products include deposit products, consumer finance, SME finance, and corporate banking services.

**v. Financial Performance:**

ABPL has total assets of 199 billion rupees. The total deposits stood at 154 billion, and the profit after taxation was Rs. 1 billion in 2022.

**vi. Branch Network:**

ABPL has a branch network of almost 227 branches in Pakistan.

**(f) Faysal Bank Limited**

**i. Introduction:**

Faysal Bank Limited was incorporated in Pakistan in the year 1994. Faysal Bank Limited was working as a conventional bank with Islamic banking branches in different cities all over Pakistan. In the year 20117, the Islamic branch network of Faysal Bank reached 197 branches, making it the first bank conventional bank to have the largest network of dedicated Islamic Branches in the country. Moreover, in 2022, Faysal Bank converted all its operations into a full-fledged Islamic Bank with a branch network of almost 700 branches.

**ii. Corporate Governance:**

The board of director consist of the Board of Directors Mr. Farooq Rahmatullah Khan is the Chairman, and Mr. Yousaf Hussain serves as the President and CEO.

**iii. Shariah Supervisory Board:**

The Shariah Supervisory Board of Faysal Islamic Bank consists of five members.

Mufti Muhammad Mohib-ul-Haq Siddiqui is the chairman of the Shariah supervisory board.

**iv. Islamic Banking Products:**

The products of Faysal Islamic bank include deposit accounts, personal finance, car finance, home finance, SME finance and specialised products such as Murabaha, Istisna'a, Diminishing Musharakah, Running Musharakah, Ijarah, Trade Services

**v. Financial Performance:**

FBL has total assets of 1074 billion rupees. The total deposits stood at 781 billion, and the profit after taxation was Rs. 11.2 billion in 2022.

**vi. Branch Network:**

ABPL has a branch network of almost 720 branches in Pakistan.

**Table 8.1: Statistics of Full-Fledges Islamic Banks**

| Bank | Year | Total Assets (2022) | Total Deposits (2022) | Profit After Taxation (2022) | No. of Branches | Chairman of Board | President/ CEO | Shariah Supervisory Board Chairman |
|---|---|---|---|---|---|---|---|---|
| Meezan Bank Pakistan | 2002 | Rs. 2.5 trillion | Rs. 1.66 trillion | Rs. 45 billion | 1003 | Mr. Riyadh S.A.A. Edrees | Mr. Irfan Siddiqui | Justice (retd) Muhammad Taqi Usmani |
| Bank Islami Pakistan Limited | 2006 | Rs. 487 billion | Rs. 416 billion | Rs. 4.4 billion | 347 | Mr. Ali Hussain | Mr. Syed Amir Ali | Mufti Irshad Ahmad Aijaz |
| Dubai Islamic Bank Pakistan Limited | 2005 | Rs. 445 billion | Rs. 345 billion | Rs. 4 billion | 210 | Mr.Mohamed Saeed Ahmed Abdulla Al Sharif | Mr. Junaid Ahmed | Dr. Sheikh Mohamed Ali Elgari |
| Al-Baraka Bank Pakistan Limited | 2010 | Rs. 236 billion | Rs. 185 billion | Rs. 1 billion | 164 | Dr. Jehad El-Nakla | Mr. Muhammad Atif Hanif | Sheikh Esam Mohammad Ishaq |
| MCB Islamic Bank Limited | 2015 | Rs. 199 billion | Rs. 154 billion | Rs. 1 billion | 227 | Mr. Raza Mansha | Mr. Zargham Khan Durrani | Prof. Mufti Munib-Ur-Rehman |
| Faysal Bank Limited | 1994 | Rs. 1074 billion | Rs. 781 billion | Rs. 11.2 billion | 720 | Mr. Farooq Rahmatullah Khan | Mr. Yousaf Hussain | Mufti Muhammad Mohib-ul-Haq Siddiqui |

### 8.2.2 Islamic Banking Branches of Conventional Banks in Pakistan

Islamic banking is performing very well and gained a prominent place in the contemporary banking industry. In Pakistan, State Bank of Pakistan issues guidelines regarding the establishment of Islamic banking branches of conventional banks to undertake Shariah-compliant businesses and operations. In addition, these guidelines encompass various areas, including minimum capital adequacy, sponsor director requirements, Shariah governance, and conditions for commencing business operations. Mandatorily, these banks are required to maintain Shariah Advisory Boards to develop Islamic banking products according to Islamic principles. As of June 2023, there are 16 Conventional Banks with Islamic Banking Branches (IBBs) actively engaged in Islamic banking business in addition to traditional banking.

**Table 8.2: Islamic banking branches of conventional banks in Pakistan (As of March 31, 2024)**

| Conventional banks with Islamic Banking Branches | No. of Branches |
|---|---|
| Allied Bank Limited | 127 |
| Askari Bank Limited | 137 |
| Bank Al Habib Limited | 221 |
| Bank Alfalah Limited | 358 |
| Habib Bank Limited | 408 |
| Habib Metropolitan Bank Limited | 208 |
| National Bank of Pakistan | 188 |
| Silk Bank Limited | 23 |
| Sindh Bank Limited | 14 |
| Soneri Bank Limited | 48 |
| Standard Chartered Bank (Pakistan) Limited | 2 |
| Bank Makramah Ltd | 14 |
| The Bank of Khyber | 126 |
| The Bank of Punjab | 158 |
| United Bank Limited | 213 |
| Zarai Taraqiati Bank Limited | 28 |
| Total | **2273** |

### 8.2.3 Islamic Windows of Conventional Banks in Pakistan

In Pakistan, regular banks have established Islamic banking counters within their conventional branches, commonly known as Islamic windows. Recognizing the importance of these Islamic banking windows, the State Bank of Pakistan (SBP) has created guidelines. These guidelines permit Islamic windows to provide various financing products to customers, including corporations, small and medium enterprises, agriculture, housing, and retail consumers. However, this is subject to meeting regulatory and Islamic banking principles requirements.

**Table 8.3: Islamic Windows of Conventional Banks in Pakistan**
**(As of March 31, 2024)**

| Conventional banks with Islamic Banking Windows | No. of Islamic Windows |
|---|---|
| Allied Bank Limited | 167 |
| Bank Al Habib Limited | 100 |
| Habib Bank Limited | 552 |
| Habib Metropolitan Bank Limited | 187 |
| National Bank of Pakistan | 152 |
| Sindh Bank Limited | 13 |
| Soneri Bank Limited | 15 |
| Standard Chartered Bank (Pakistan) Limited | 38 |
| Bank Makramah Ltd | 34 |
| The Bank of Punjab | 147 |
| United Bank Limited | 501 |
| Zarai Taraqiati Bank Limited | 10 |
| Total | **1916** |

## 8.3 Performance of Islamic Banks in Pakistan.

By the end of the March 2024 quarter, the assets of the Islamic Banking Industry (IBI) had risen by PKR 241 billion, reaching PKR 9,235 billion. Similarly, IBI deposits continued to grow, increasing by PKR 126 billion during this period to reach PKR 6,875 billion. Year-on-year (YoY) growth rates for IBI assets and deposits were recorded at 22.6 percent and 28.5 percent, respectively. Net financing saw yearly growth of 1.0 percent, amounting to PKR 3,259 billion, while net investments surged by 41.3 percent to PKR 4,405 billion.

In terms of market share within the overall banking industry, IBI's assets and deposits constituted 19.9 percent and 23.2 percent, respectively. Additionally, the market share of IBI's net financing and net investments stood at 28.0 percent and 16.3 percent, respectively, by the end of March 2024.

**Table 8.4: Key Performance Indicators of Islamic Banks of Pakistan**

| Particulars | Period | | | Yearly Growth (YoY) | | | Share in Overall Banking Industry (%) | | |
|---|---|---|---|---|---|---|---|---|---|
| | Mar-23 | Dec-23 | Mar-24 | Mar-23 | Dec-23 | Mar-24 | Mar-23 | Dec-23 | Mar-24 |
| Assets | 7,532 | 8,994 | 9,235 | 26.7 | 24.4 | 22.6 | 19.4 | 19.4 | 19.9 |
| Deposits | 5,352 | 6,749 | 6,875 | 26.0 | 30.8 | 28.5 | 21.5 | 23.2 | 23.2 |
| Investments (net) | 3,118 | 4,235 | 4,405 | 41.6 | 38.8 | 41.3 | 15.8 | 16.3 | 16.3 |
| Financing (net) | 3,226 | 3,335 | 3,259 | 19.8 | 7.1 | 1.0 | 27.5 | 27.4 | 28.0 |
| Number of Islamic Banking Institutions | 22 | 22 | 22 | - | - | - | - | - | - |
| Number of Branches | 4,427 | 4,955 | 5,101 | 10.9 | 12.7 | 15.2 | - | - | - |
| Number of Islamic Banking Windows | 1,832 | 1,922 | 1,916 | 25.4 | 26.8 | 4.6 | - | - | - |
| **number includes sub-branches* | | | | | | | | | |

**Source: Islamic Banking Bulletin March 2024**

The Islamic banking industry is comprised of 22 institutions, including 6 full-fledged Islamic banks and 16 conventional banks with dedicated Islamic banking branches. This network extends across the country with a total of 5101 branches. Additionally, there are 1916 Islamic banking windows, offering Shariah-compliant banking services to the public.

## 8.4 Performance of Islamic Banks across the World

As of the conclusion of 2022, the size of Islamic banking assets reached USD 3.25 trillion, compared to USD 3.06 trillion in 2021, representing 69.3% of the total value of global Islamic finance and banking assets, a slight increase from 68.7% in the previous year. Throughout 2022, Islamic banking experienced a growth of 6.9% in assets. It maintained a high level of capitalization, profitability, and liquidity, facilitating financing for both households and businesses and contributing to economic recovery efforts. There are 15 jurisdictions where Islamic banking is considered systemically important, meaning that the total Islamic banking assets in these countries make up more than 15% of their total domestic banking sector assets. Collectively, these jurisdictions represent USD 2,071.9 billion, constituting 92.1% of the total global Islamic banking assets.

**Table 8.5: Islamic Banking Performance Globally**

| Metric | Value |
|---|---|
| Total Islamic Banking Assets (2022) | USD 3.25 trillion |
| Total Islamic Banking Assets (2021) | USD 3.06 trillion |
| Percentage of Global Islamic Finance Assets (2022) | 69.3% |
| Percentage of Global Islamic Finance Assets (2021) | 68.7% |
| Growth Rate of Islamic Banking Assets (2022) | 6.9% |
| Systemically Important Jurisdictions (Total) | 15 |
| Total Assets in Systemically Important Jurisdictions | USD 2,071.9 billion |
| Percentage of Global Islamic Banking Assets (Systemic) | 92.1% |

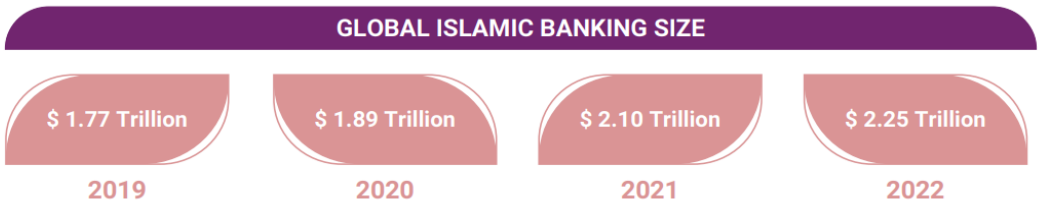



**Figure 8.1: Global Islamic Banking Size**
**Source: IFSB (2023)**

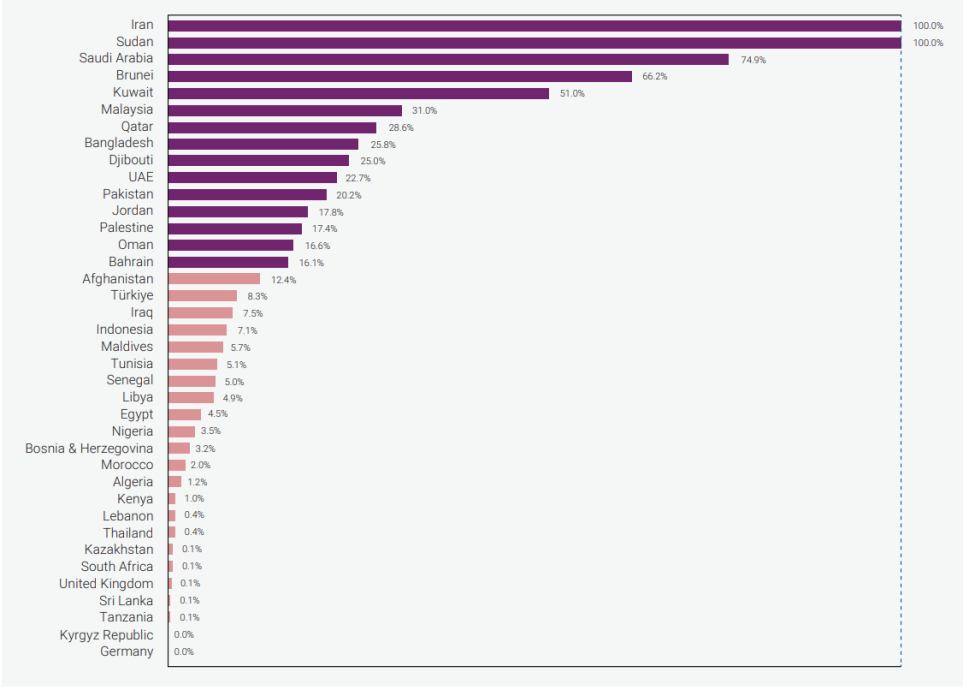



**Figure 8.2: Islamic Banking Share in Total Banking Assets by Jurisdiction (%) (2022)**
**Source: IFSB (2023)**

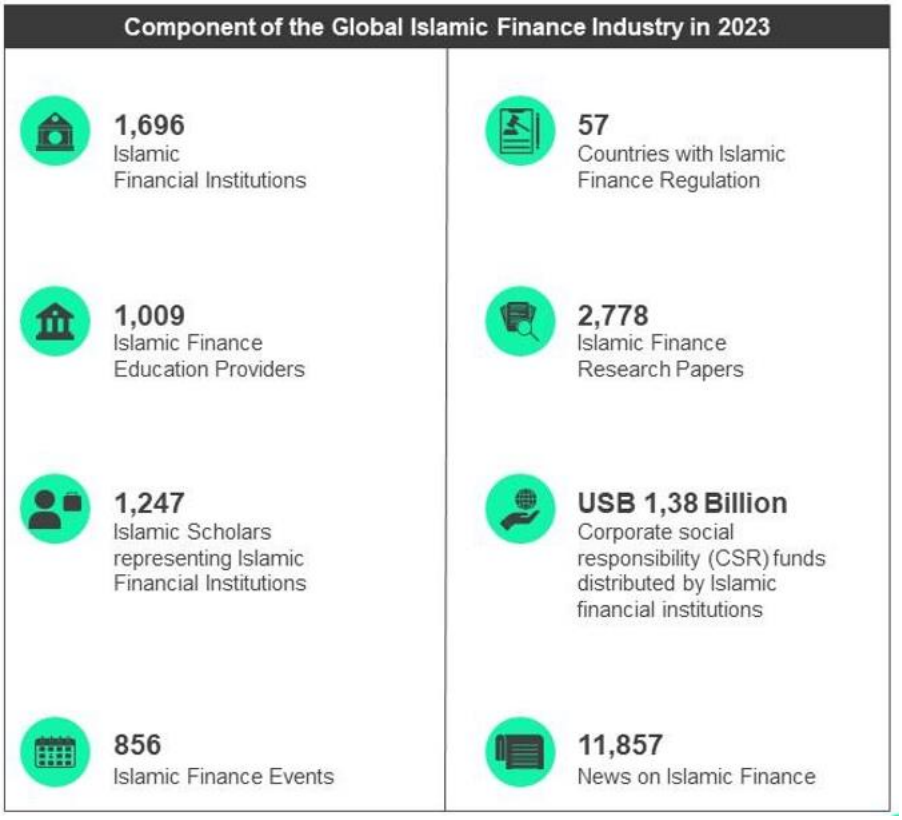



**Figure 8.3: Components of the Global Islamic Finance Industry 2023**
**Source: Google**

## SUMMARY

This unit provides a comprehensive examination of the current landscape of Islamic banking in Pakistan. It begins by tracing the historical context of Islamic banking in the country and explaining key milestones and developments that have shaped its evolution. The unit then provides an overview of the various types of Islamic banking institutions operating in Pakistan, including full-fledged Islamic banks, Islamic branches of conventional banks, and Islamic windows of conventional banks evaluating their structures, governance, and market presence. Additionally, the unit analyzes the performance of Islamic banking in Pakistan, analyzing key financial indicators to gauge its growth and impact within the financial sector. Finally, the unit concludes with an analysis of Islamic banking performance in Pakistan and worldwide.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
   i. What are full-fledged Islamic banks?
   ii. What are the Islamic Banking windows of conventional banks?
   iii. What are the Islamic banking branches of Islamic banks?

2. Write long notes on the following questions.
   i. History of Islamic Banking in Pakistan.
   ii. Full-fledged Islamic Banks in Pakistan.
   iii. Islamic banking performance in Pakistan and worldwide.

3. Please fill in the blank spaces.
   i. ……. is the first Islamic bank of Pakistan.
   ii. In year …… Council of Islamic Ideology (CII) declared the interest-based system against Islam.
   iii. …….initiated its operations in 2005 as a wholly owned subsidiary of Dubai Islamic Bank UAE, which is the world's first Islamic Bank.
   iv. Shariah board of Islamic banks consists of at least……. members.

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**Unit–9**

# FINANCIAL ACCOUNTING AND REPORTING FOR ISLAMIC BANKS

**Written by: Dr. Nosheen**

**Reviewed by: Dr. Muhammad Suleman Afzal**

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## INTRODUCTION

This unit discusses the critical aspect of financial reporting within the realm of Islamic banking. Financial reporting serves as a cornerstone in evaluating the performance, transparency, and compliance of Islamic financial institutions. This unit explores the fundamentals of financial reporting, and its application in Islamic financial institutions. Moreover, it highlights the significance of adopting specialized standards, such as those developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), to ensure accurate and Shariah-compliant reporting practices.

## OBJECTIVES

At the end of this unit, you will be able to

i. Understand the concept of financial reporting and its significance in assessing the financial health and compliance of Islamic banks.

ii. Explore how financial reporting is tailored to meet the unique requirements of Islamic financial institutions, considering their adherence to Shariah principles and ethical standards.

iii. Familiarize with the conceptual framework established by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), providing a foundation for Shariah-compliant financial reporting practices.

## 9.1 What is Accounting?

Financial accounting is the process of measuring business operations and activities and processing these measurements into information for making informed decisions by internal and external decision-makers of an organization. Internal decision-makers include company management, while external decision-makers are mainly investors and customers.

The accounting process includes three main activities:

1. Recognizing, recording, classifying, and summarizing business transactions.
2. Measuring, analyzing, processing, and interpreting operating results.
3. Reporting and presenting the financial position.

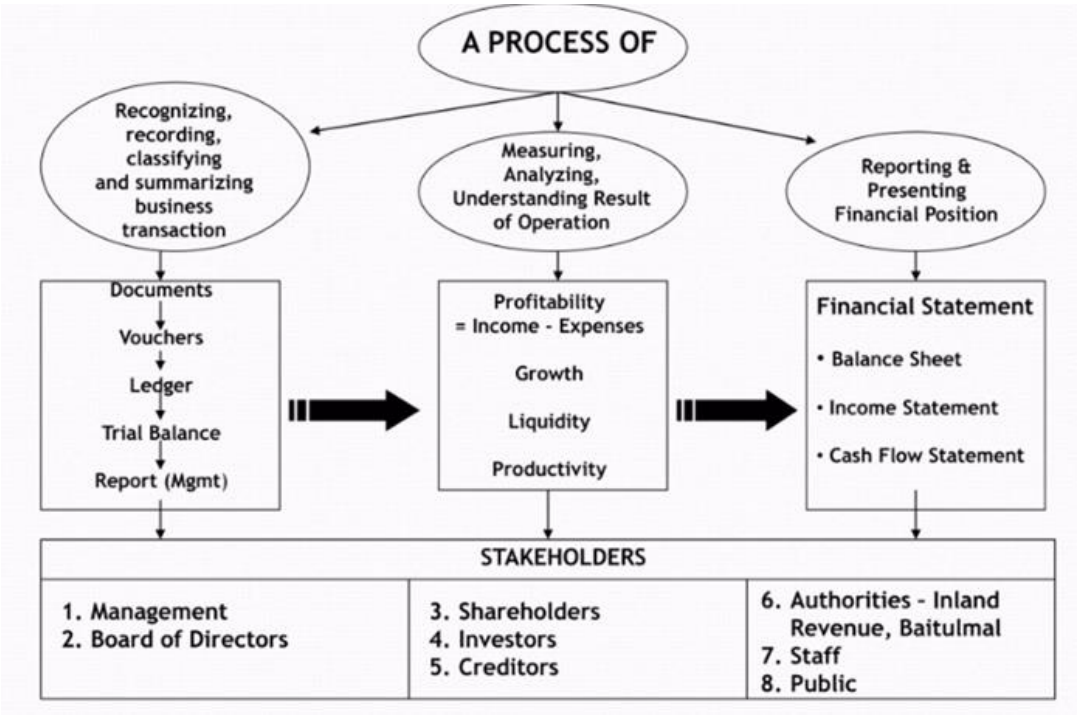



**Figure 1: Accounting Process**
**Source: Google Search**

## 9.2 What is Islamic Accounting?

Islamic accounting is defined as the accounting process that delivers relevant information, which may include non-financial data, to an entity's stakeholders. This information ensures that the entity consistently operates in compliance with Islamic Sharīʿah principles and fulfils its socio-economic goals.

### 9.2.1 An Islamic Perspective of Accounting Concepts

In the Qur'an, the term for accounting or accountability is "hisab." The concept of "hisab," or its derivative "muhasabah," pertains to individual spiritual reckoning in Islam.

i. The Holy Qur'an emphasizes the importance of accountability in all human actions and commercial transactions.
ii. Complete transparency and accountability, both social and financial, are essential.
iii. Islamic financial institutions must provide comprehensive information on all transactions to users and fulfil their social responsibilities.
iv. Muslim accountants carry more responsibilities compared to their non-Muslim counterparts. This increased responsibility stems from the expectation that Islamic accountants grasp the religious principles underlying their profession.

The comprehensive nature of Islamic accounting is detailed in Surah al-Baqarah, verse 282, which is known as the "verse on debt" or Ayat al-Dain.

Allah says,

> *"O believers! When you contract a loan for a fixed period, commit it to writing. Let the scribe maintain justice between the parties. The scribe should not refuse to write as Allah has taught them to write. They will write what the debtor dictates, bearing Allah in mind and not defrauding the debt……" Surah Al-Baqarah (2:282)*

### 9.2.2 The Significance of Accountability in Islam

The importance of accountability, especially in financial transactions, is highlighted by several Islamic concepts:

i. Khilafah (vicegerency خليفة, the responsible management of resources)
ii. Taklif (responsibility تكليف, which denotes individuals' duties toward their Creator.
iii. The requirement for recording financial transactions.
iv. Islamic inheritance law (مواريث).
v. The computation of obligatory almsgiving (zakat زكاة).
vi. The fundamental principle of Tawhid (unity of God التوحيد).

### 9.2.3 Objectives of Islamic Accounting

The objective of Islamic accounting includes:

i. Accurate determination of income.
ii. Reporting of accurate income information
iii. Encouraging efficiency and leadership.
iv. Adhering to Sharī‘ah principles.
v. Upholding justice.

vi. Following best reporting practices.
vii. Embracing positive social change through corporate social responsibility.

### 9.2.4 Users of Accounting Information in Islamic Banks

Like conventional accounting, the users of accounting information for Islamic banks include a range of stakeholders who need this information to make informed decisions:

i. Equity holders.
ii. Investment account holders and other deposit holders.
iii. Holders of current and savings accounts.
iv. Individuals and entities conducting transactions with the Islamic bank, who are neither equity nor account holders.
v. Zakat agencies.
vi. Regulatory bodies.

## 9.3 What is Financial Reporting?

Financial reporting is the systematic accounting process designed for communicating financial information. Financial reporting involves conveying financial information to both external and internal stakeholders through the presentation of "core" financial statements. The goal is to provide a comprehensive and transparent picture of an entity's financial health and operations, meeting the diverse needs of stakeholders. Financial reports are required to adhere to accounting and reporting.

### 9.3.1 International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are a set of principles-based accounting standards established by the International Accounting Standards Board (IASB), an independent, non-profit organization and standard-setting body.

IFRS provides broad guidelines rather than specific standards for individual industries, making them particularly relevant for large multinational corporations with operations in multiple countries. This uniformity allows these companies to apply the same accounting standards across their various subsidiaries, ensuring that both potential investors and auditors have a consistent view of the company’s financial situation.

The main objectives of IFRS are to:

i. Develop a single set of high-quality, understandable, enforceable, and globally accepted financial reporting standards.
ii. Encourage the use and strict application of these standards.
iii. Address the financial reporting needs of emerging economies and small to medium-sized enterprises (SMEs).
iv. Facilitate the convergence of national accounting standards with IFRS.

## 9.4 Financial Reporting for Islamic Financial Institutions

Since IFRS is tailored to conventional business models, its application to Islamic financial institutions presents challenges. Many IFRS do not address specific Islamic finance practices, such as Mudarabah, and some are not applicable at all. Islamic banks have unique needs regarding transactions, reporting, and disclosure, necessitating alternative accounting and financial reporting standards. To accurately report Islamic transactions, additional disclosure is often required to help users fully comprehend the transaction and its accounting treatment. This may involve detailing the nature of each Shariah contract used by the Islamic financial institution.

## 9.5 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

The establishment of the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was driven by the need for an Islamic accounting framework that addresses financial reporting, assurance, governance, accountability, and other relevant aspects specific to Islamic financial institutions. AAOIFI has been at the forefront of developing standards for Islamic accounting, auditing, governance, ethics, and Shariah compliance.

Founded in 1990, AAOIFI emerged from the necessity to create international accounting standards for Islamic financial products. It is an independent, non-governmental organization formed through the collaborative efforts of leading banks and financial institutions within the Muslim world.

AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) has formulated a Conceptual Framework outlining the objectives and value-based principles that guide the accounting and reporting of financial information for Islamic financial institutions (IFIs). The primary focus of this Conceptual Framework is to demonstrate the purpose of financial reporting and accounting for IFIs towards their shareholders, members, and stakeholders.

AAOIFI has issued a total of 117 standards which include Shariah standards, accounting standards and auditing, governance and code of ethics standards for Islamic financial institutions. This organization gathers support from a diverse range of institutional members, including central banks, regulatory authorities, financial institutions, accounting and auditing firms, and legal firms, representing over 45 countries.

AAOIFI Accounting standards provide 33 accounting standards for information regarding the financial reporting of Mudarabah financing, Salam financing, Istisna financing, investment in real estate, investment in sukuks, financial reporting for zakar, reporting for real estate etc.

### 9.5.1 Objectives of AAOIFI Accounting Standards

The goals of financial accounting standards for Islamic banks and financial institutions, as outlined by AAOIFI, are:

i. To guide financial accounting standards boards in the development of standards for Islamic banks and financial institutions.
ii. To aid Islamic banks in choosing among various accounting treatments in the absence of established accounting standards.
iii. To offer a framework and regulate management's subjective judgments in preparing financial statements and reports.
iv. To enhance users' confidence and understanding of accounting information, thereby increasing trust in Islamic banks.
v. To develop accounting standards that are likely to be consistent and harmonious with one another.

### 9.5.2 AAOIFI Proposed Set of Financial Statements for Islamic Banks

According to AAOIFI, the financial statements of an Islamic bank are divided into three categories.

1. The first category comprises the financial statements that are meant to reflect the position of the Islamic bank as an investor, such as:
    i. Statement of Financial Position
    ii. Statement of Income
    iii. Statement of Cash Flows
    iv. Statement of Retained Earnings or Statement of Changes in Owners' Equity

2. The second category focuses on the financial reporting of restricted investments managed by the Islamic bank for the benefit of others
    i. Statement of Changes in Restricted Investments

3. The third category includes financial statements reflecting the Islamic bank's role as a fiduciary of funds made available for social services
    i. Statement of Sources and Uses of Funds in the Zakah & Charity Fund
    ii. Statement of Sources and Uses of Funds in the Qard Fund.

    Furthermore, it includes.
    i. Notes to the financial statements
    ii. Independent Auditors' Report,
    iii. Shariah Audit Committee Report:
    iv. Any statements, reports and other data that assist in providing information required by users of financial statements as specified in the Statement of Objectives.

## 9.6 Financial Statements in Islamic Financial Institutions

A financial statement serves as a formal record of a business entity's financial activities and transactions. It represents the result of all financial dealings, systematically sorted, classified, and presented according to bookkeeping principles. These recorded transactions encompass any business interactions between the entity and other corporations, organizations, or individuals.

Financial statements are crucial for top management, offering vital information to aid in decision-making. They assess the business's performance, providing essential insights into ongoing success or highlighting areas of poor performance.

### 9.6.1 Four Basic Financial Statements

The four basic financial statements in Islamic financial reporting are

i. Balance sheets
ii. Income statements
iii. Cash flow statements
iv. Statement of retained earnings or shareholders' equity

#### 9.6.1.1 Balance Sheet

Balance Sheets, also known as the Statement of Financial Position, provide a snapshot of a company's financial position. It presents a summary of the company's assets, liabilities, and ownership equities as of the end of a particular financial year. According to AAOIFI accounting standards, the following are the disclosure requirements of the Balance sheet.

- Assets and liabilities should be categorized according to their nature and presented in the statement of financial position based on their relative liquidity.
- The statement of financial position should display separate totals for assets, liabilities, unrestricted investment accounts and their equivalents, and owners' equity.

**Assets Disclosure:**

The balance sheet should disclose the following Assets:

- Cash and cash equivalent
- Receivables (Murabaha, Salam, Istisnaa)
- Investment securities
- Mudarabah investment
- Musharakah investment
- Investment in other entities
- Inventories.
- Investment in real estate
- Assets acquired for leasing
- Other investments (disclosure of their types)
- Fixed assets (disclosure of depreciation for significant asset types)
- Other assets (disclosure of significant types).

**Liabilities Disclosure:**

The balance sheet should disclose the following liabilities:

- Current accounts, saving accounts and other accounts with separate disclosure of each category of accounts
- Deposits of other banks
- Salam Payable

- Istisnaa Payable
- Declared but undistributed profits
- Zakah and taxes payable
- Other accounts payable
- Disclosure of equity of unrestricted account holders
- It is a mandatory requirement to disclose and present the unrestricted investment accounts and their equivalent in the statement of financial position as a separate item between liabilities and owner's equity.
- Authorized, subscribed and paid-in capital
- Number of authorized ownership units (shares), number of issued ownership units, number of outstanding ownership units, par value per unit, and premiums on issued unit
- Legal reserve and discretionary reserves at the beginning and end of the period and changes therein during the period
- Retained earnings at the beginning and end of the period and amount of retained earnings resulting from the revaluation of assets and liabilities to their cash equivalent values, where applicable, and changes therein during the period including distribution to owners and transfers to or from reserves
- other changes in owners' equity during the period
- any restrictions imposed on the distribution of retained earnings to owners.

**9.6.1.2 Income Statement**

The Income Statement measures a company's financial performance over a specific period, showing how revenue is converted into net income. It is also known as the Profit and Loss Statement, Statement of Operations, or Statement of Income. This statement is very important for businesses as it reveals the profitability of an entity by detailing investment revenues, expenses, gains, and losses incurred during the period.

According to AAOIFI, after the heading of the income statement and the period covered by the income statement, the following information must be disclosed separately: investment revenues, expenses, gains, and losses jointly financed by the Islamic bank and unrestricted investment account holders, as well as those exclusively financed by the bank.

**Revenue Recognition**

These are gross increases in assets or reductions in liabilities, or a mix of both, arising from legitimate investments, trading activities, and providing services, including the management of restricted investment accounts.

- The bank must have earned the right to receive the revenue through a fully completed process.
- Another party must be obligated to remit a fixed or determinable amount to the bank.
- The amount should be known and collectable, if it has not already been collected.

**Expenses Recognition**
These are the opposite of revenues. Expenses are the costs incurred by a business in the process of earning revenue.

Expenses are recognized when they are realized, either:
- Because they are directly related to the earning of revenues that have been realized (e.g., transportation costs for services), or
- Because they are indirect costs related to the period covered by the income statement (e.g., bonuses).

**Gains (losses)**
A gain is a net increase in net assets arising from:
- Holding assets that appreciate during the period covered by the income statement,
- Incidental legitimate reciprocal transactions (e.g., sale of assets not acquired for sale), or
- Non-reciprocal transfers (e.g., donations).

**Net Income (Net Loss)**:
The net increase (decrease) in owners' equity.
- Results from revenues, expenses, gains, and losses, after accounting for the return on unrestricted investment accounts and their equivalents for the period.
- It represents the outcome of all ongoing profit-oriented operations of the bank, as well as other events and circumstances.

**Income statement Disclosure:**
Period covered by the income statement.

Revenues and gains from investments
(-) Expenses and losses from investments
(=) Income (loss) from investments
(-) Share of unrestricted investment account holders in income (loss) from investments before the bank's share as Mudarib
(=) The bank's share in income (loss) from investments
(+) The bank's share in unrestricted investment income as Mudarib
(+) The bank's share in restricted investment profit as Mudarib
(+) The bank's fixed fee as an investment agent for restricted investment
(=/-) Other revenues, expenses, gains and losses
(-) General and administrative expenses
(=) Net income (loss) before Zakah and taxes
(-) Zakah and taxes (separate disclosures)
(=) Net income (loss)

### 9.6.1.3 Cash Flow Statements

Cash flow statements are also known as the statement of cash flow or funds flow statements. It shows how changes in balance sheet accounts and income statements impact cash and its equivalents. This statement aims to identify the sources and uses of cash during the financial year.

According to AAOIFI standards, the statement of cash flows should distinguish between cash flows from operations, investing activities, and financing activities.

**Disclosure:**

i. Net increase (or decrease) in cash and cash equivalents during the period, and the balance of cash and cash equivalents at the beginning and end of the period.
ii. Transactions and transfers that do not involve cash payments or receipts should be disclosed, such as bonus shares or acquiring assets in exchange for company equity shares.

### 9.6.1.4 Statement of Retained Earnings or Shareholders' Equity

A financial statement that outlines changes in a company's retained earnings over a specific period is known as the Statement of Retained Earnings. It may also be referred to as the Statement of Retained Earnings & Stockholders' Equity (for corporations).

According to AAOIFI standards, the statement of changes in owners' equity should include:

i. Retained earnings at the beginning of the period, with a separate disclosure of any estimated retained earnings resulting from asset and liability revaluations, if applicable.
ii. Net income (or loss) for the financial reporting period.
iii. Transfers to legal and discretionary reserves during the period.
iv. Distributions to owners during the period.
v. Retained earnings at the end of the period, with a separate disclosure of any estimated retained earnings resulting from asset and liability revaluations, if applicable.

## 9.7 Key Areas of AAOIFI Accounting Standards

Other areas of AAOIFI accounting standards include

i. Income recognition, particularly from equity-type transactions such as Musharaka and Mudharaba.
ii. Valuation of assets and liabilities
iii. disclosure of transactions, presentation of financial assets and liabilities,

iv. valuation, presentation, and disclosure of inventories owned by Islamic Financial Institutions arising from Murabaha (cost-plus sale) contracts.
v. difficulties arise in handling obligations and rights created through various modes of Islamic finance, Zakat provisions, and Sadaqah.
vi. Obligations and rights resulting from certain Salaam-based transactions.

**Table 9.1: Islamic Banks Balance Sheet**

<table>
<tr><th>Assets</th><th>Liabilities</th></tr>
<tr><td rowspan="2">Cash and liquid securities</td><td>Demand deposits (qard al hasan, wakala)</td></tr>
<tr><td>Interbank murâbaḥah</td></tr>
<tr><td>Interbank murâbaḥah</td><td rowspan="2">Unrestricted profit sharing investment accounts (mudârabah)</td></tr>
<tr><td rowspan="3">Inventory (real estate, automobiles, commodities, etc.)<br>Asset-backed transactions (murâbaḥah, ijārah, salam, and istisna’)</td></tr>
<tr><td>Restricted profit-sharing investment accounts (mudârabah) 1/</td></tr>
<tr><td>Reserves (PER, IRR)</td></tr>
<tr><td>PLS transactions (mudârabah, musharakah )</td><td rowspan="2">Shareholders’ equity capital</td></tr>
<tr><td>Fee-based services (wakalah, kafalah) 2/</td></tr>
</table>

[1] **Source: IMF working paper**

[1] 1/ Restricted profit-sharing investment accounts are generally included off-balance sheet.

2/ Fee-based services include letters of credit, letters of guarantee, safekeeping of negotiable instruments and the collection of payments, internal and external transfer operations, hiring coffers, administration of real estate or projects, and administration of wills. Most of them are generally included off-balance sheet.

Profit equalization reserves (PER) are allocated from operating income for smoothing purposes, prior to deducting the the mudarib’s (bank’s) share.

Investment risk reserves (IRR) are set aside from the income share of investment account holders as a cushion for future losses that they may incur.

## SUMMARY

This unit provides an in-depth exploration of financial accounting and reporting within the context of Islamic banking. Beginning with an understanding of financial accounting fundamentals, the unit progresses to examine its tailored application in Islamic financial institutions. Next, the unit emphasises the significance of financial reporting in promoting transparency and compliance with Shariah principles. The unit introduces the conceptual framework established by AAOIFI and explores its standards governing financial reporting practices. By the conclusion of this unit, learners will have gained a comprehensive understanding of the principles, standards, and challenges associated with financial reporting in Islamic banks, equipping them with essential knowledge for navigating this critical aspect of Islamic finance.

## SELF-ASSESSMENT QUESTIONS

1. Please provide short answers to the following questions.
   i. What is financial reporting?
   ii. What are the components of the annual financial report of an Islamic Financial Institution?
   iii. What types of information do financial reports are required to provide?

2. Write long notes on the following questions.
   i. Significance of Financial reporting in the context of Islamic banking.
   ii. Describe AAOFI – Conceptual framework.
   iii. Financial statements in Islamic Reporting

3. Please fill in the blank spaces.
   i. ……. is the systematic accounting process designed for communicating financial information?
   ii. ……. serves the needs of a company's senior management team
   iii. ……presents the financial position of a company at a specific date.
   iv. AAOIFI has issued a total of …… standards which include Shariah standards, accounting standards and auditing, governance and code of ethics standards for Islamic financial institutions.

# REFERENCES


## Books

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Ahmad, A. R. Y. (2010). Islamic modes of finance and the role of Sukuk. *Islamic Finance Instruments and Markets. London*, 7–10.

## Articles

Salman, K. R. (2022) "Exploring the History of Islamic Accounting and the Concept of Accountability in an Islamic Perspective". *Journal of Islamic Economic and Business Research,* 2(2), 114–130.

Ebrahim, Mohamed. (2019). Financial Reporting for Islamic Financial Institutions. 10.6084/m9.figshare.10067492.

Hussain, M., Shahmoradi, A., & Turk, R. (2016). An overview of Islamic finance. *Journal of International Commerce, Economics and Policy*, *7*(01), 1650003.

## Reports and Websites

AAOIFI Financial Accounting Standard 1 General Presentation and Disclosures in the Financial Statements of Islamic Banks and Financial Institutions (Revised 2021)

# ANNEXURES

## Balance Sheet

**MEEZAN BANK LIMITED**
**CONSOLIDATED STATEMENT OF FINANCIAL POSITION**
**AS AT DECEMBER 31, 2023**

| | Note | 2023 | 2022 |
|---|---|---|---|
| | | (Rupees in '000) | |
| **ASSETS** | | | |
| Cash and balances with treasury banks | 7 | 242,612,195 | 117,743,672 |
| Balances with other banks | 8 | 11,458,281 | 13,710,753 |
| Due from financial institutions | 9 | 34,964,299 | 34,964,299 |
| Investments | 10 | 1,578,341,536 | 1,287,316,423 |
| Islamic financing and related assets | 11 | 961,673,012 | 995,508,354 |
| Fixed assets | 12 | 59,162,699 | 40,624,658 |
| Intangible assets | 13 | 2,370,686 | 1,873,518 |
| Deferred tax assets | 19 | - | 4,439,835 |
| Other assets | 14 | 128,733,444 | 85,719,066 |
| | | 3,019,316,152 | 2,581,900,578 |
| **LIABILITIES** | | | |
| Bills payable | 15 | 39,724,176 | 40,175,122 |
| Due to financial institutions | 16 | 377,494,612 | 573,326,439 |
| Deposits and other accounts | 17 | 2,217,420,536 | 1,658,469,588 |
| Sub-ordinated sukuks | 18 | 20,990,000 | 20,990,000 |
| Deferred tax liabilities | 19 | 4,881,310 | - |
| Other liabilities | 20 | 168,788,249 | 169,804,739 |
| | | 2,829,298,883 | 2,462,765,888 |
| **NET ASSETS** | | 190,017,269 | 119,134,690 |
| **REPRESENTED BY** | | | |
| Share capital | 21 | 17,912,532 | 17,896,243 |
| Reserves | 22 | 37,106,473 | 28,212,137 |
| Surplus / (deficit) on revaluation of assets - net of tax | 23 | 10,920,597 | (663,671) |
| Unappropriated profit | | 122,528,058 | 72,485,599 |
| Total equity attributable to the equity holders of the Holding Company | | 188,467,660 | 117,930,308 |
| Non-controlling interest | 24 | 1,549,609 | 1,204,382 |
| | | 190,017,269 | 119,134,690 |
| **CONTINGENCIES AND COMMITMENTS** | 25 | | |

# Income Statement

**MEEZAN BANK LIMITED**
**CONSOLIDATED PROFIT AND LOSS ACCOUNT**
**FOR THE YEAR ENDED DECEMBER 31, 2023**

| | Note | 2023 | 2022 |
|---|---|---|---|
| | | ----------Rupees in '000---------- | |
| Profit / return earned on Islamic financing and related assets, investments and placements | 26 | 431,820,608 | 232,245,452 |
| Profit / return on deposits and other dues expensed | 27 | 205,327,453 | 110,426,062 |
| Net profit / return | | 226,493,155 | 121,819,390 |
| **OTHER INCOME** | | | |
| Fee and commission income | 28 | 19,636,228 | 14,729,321 |
| Dividend income | | 635,019 | 629,478 |
| Foreign exchange income | | 3,094,654 | 3,617,274 |
| Loss on securities | 29 | (697,998) | (100,184) |
| Other income | 30 | 1,306,765 | 1,238,374 |
| Total other income | | 23,974,668 | 20,114,263 |
| **Total income** | | 250,467,823 | 141,933,653 |
| **OTHER EXPENSES** | | | |
| Operating expenses | 31 | 68,771,751 | 46,841,953 |
| Workers welfare fund | 20.6 | 3,655,940 | 1,927,520 |
| Other charges | 32 | 304,830 | 95,150 |
| Total other expenses | | 72,732,521 | 48,864,623 |
| | | 177,735,302 | 93,069,030 |
| Share of profit / (loss) of associates | | 1,671,989 | (87,366) |
| Profit before provisions | | 179,407,291 | 92,981,664 |
| Provisions and write offs - net | 33 | 7,340,411 | 4,176,661 |
| Extra ordinary / unusual items | | - | - |
| **Profit before taxation** | | 172,066,880 | 88,805,003 |
| Taxation | 34 | 86,043,744 | 43,663,751 |
| **Profit after taxation** | | 86,023,136 | 45,141,252 |
| **Attributable to:** | | | |
| Equity holders of the Holding Company | | 85,430,550 | 44,936,695 |
| Non-controlling interest | | 592,586 | 204,557 |
| | | 86,023,136 | 45,141,252 |
| | | **Rupees** | |
| Basic earnings per share | 35.1 | 47.72 | 25.11 |
| Diluted earnings per share | 35.2 | 47.66 | 25.10 |

# Cash Flow Statement

**MEEZAN BANK LIMITED**
**CONSOLIDATED CASH FLOW STATEMENT**
**FOR THE YEAR ENDED DECEMBER 31, 2023**

| | Note | 2023 | 2022 |
|---|---|---|---|
| | | (Rupees in '000) | |
| **CASH FLOW FROM OPERATING ACTIVITIES** | | | |
| Profit before taxation | | 172,066,880 | 88,805,003 |
| Less: Dividend income | | (635,019) | (629,478) |
| Share of (profit) / loss of associates | | (1,671,989) | 87,366 |
| | | 169,759,872 | 88,262,891 |
| **Adjustments:** | | | |
| Depreciation | 31 | 4,422,612 | 3,177,882 |
| Amortisation | 31 | 560,697 | 469,666 |
| Non cash items related to right-of-use assets | 27 & 31 | 4,937,939 | 4,657,904 |
| Provisions and write offs - net | 33 | 7,340,411 | 4,176,661 |
| Share based compensation expense | 31.1 & 40 | 409,746 | 293,962 |
| Charge for defined benefit plan | 31 | 810,438 | 629,796 |
| Gain on sale of operating fixed assets | 30 | (451,994) | (215,770) |
| Unrealised loss / (gain) - held for trading | 29 | 18 | (18) |
| | | 18,029,867 | 13,190,083 |
| | | 187,789,739 | 101,452,974 |
| **(Increase) / decrease in operating assets** | | | |
| Due from financial institutions | | - | 203,437,338 |
| Islamic financing and related assets | | 26,293,235 | (240,666,103) |
| Other assets | | (43,090,050) | (21,701,668) |
| | | (16,796,815) | (58,930,433) |
| **Increase / (decrease) in operating liabilities** | | | |
| Bills payable | | (450,946) | 4,033,744 |
| Due to financial institutions | | (195,831,827) | 352,912,205 |
| Deposits and other accounts | | 558,950,948 | 202,598,508 |
| Other liabilities | | (14,666,176) | 75,747,451 |
| | | 348,001,999 | 635,291,908 |
| | | 518,994,923 | 677,814,449 |
| Contribution to defined benefit plan | | (677,192) | (557,689) |
| Income tax paid | | (80,865,248) | (38,388,893) |
| **Net cash generated from operating activities** | | 437,452,483 | 638,867,867 |
| **CASH FLOW FROM INVESTING ACTIVITIES** | | | |
| Net investments in available-for-sale securities | | (266,279,529) | (531,153,574) |
| Net investments in held-to-maturity securities | | 1,097,671 | (141,110,504) |
| Net divestments / (investments) in held-for-trading securities | | 2,470 | (2,470) |
| Net (divestments) / investments in associates | | (1,019,796) | 596,865 |
| Dividends received | | 635,708 | 632,621 |
| Investments in operating fixed assets | | (15,056,668) | (10,999,090) |
| Investments in intangible assets | | (1,057,865) | (837,603) |
| Proceeds from sale of fixed assets | | 676,208 | 375,048 |
| **Net cash used in investing activities** | | (281,001,801) | (682,498,707) |
| **CASH FLOW FROM FINANCING ACTIVITIES** | | | |
| Payment of lease liability against right-of-use assets | | (3,869,901) | (3,780,665) |
| Proceeds against issue of shares | | 99,699 | - |
| Dividend paid to equity shareholders of the Bank | | (29,819,429) | (7,908,045) |
| Dividend paid to non-controlling interest | | (245,000) | (192,500) |
| **Net cash used in financing activities** | | (33,834,631) | (11,881,210) |
| Increase / (decrease) in cash and cash equivalents | | 122,616,051 | (55,512,050) |
| Cash and cash equivalents at the beginning of the year | 36 | 131,454,425 | 186,966,475 |
| **Cash and cash equivalents at the end of the year** | 36 | 254,070,476 | 131,454,425 |

_____[ ]_____