

Financial Transactions in Islamic Banking are Viable Alternatives to the Conventional Banking Transactions

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Abstract

Islam has prohibited riba (interest) on loan given. When a lender lends money to another person, he is allowed to get back the capital amount only and not any additional amount which is usually fixed interest on the capital. Taking interest on loan given caused cruelty and injustice to poor people in the society during prophet Muhammad's time who were unable to pay back the capital and the interest. So, Prophet Muhammad encouraged the rich people to give qard al-hasan (interest free loan) to the poor and needy people to help them to solve their problems. That's why Allah (the Creator) prohibited taking interest but encouraged people who have money to invest the money in business. The profit obtained from business is permitted (halal) but fixed rate interest taken on loan given to a person is riba (interest) and it is prohibited. As Allah (the Creator) has prohibited interest, Muslims are prohibited to give interest, to take interest and to write down the interest transaction. Hence, Muslim scholars have invented some Islamic transactions which do not involve interest and Islamic banks are adopting these Islamic transactions. The objective of this paper is to narrate and analyze the Islamic banking transactions which are interest free and they are considered as alternatives to the conventional banking transactions.

Keywords: Islamic financial transactions, Islamic banking, Islamic finance, alternative financial transactions, conventional financial transactions, prohibition of riba (interest), profit-loss sharing (PLS).

Introduction

The traditional banks in the world started banking business a few hundred years ago. They were taking deposits from the people in the savings and current accounts and were giving loan to people for interest (riba). Riba (interest) is prohibited in Islam. So, Islamic financial system cannot operate based on riba (Rahman, 2007). As those traditional banks were operating based on interest, Muslim scholars in the world were thinking for a long time how to develop a banking system which will be operated based on *shariah* (Islamic law) principles and will not take any interest on loan given to people. They were thinking to operate Islamic banking based on profit-loss sharing mechanism which is approved by *shariah*. In 1973, extensive collective efforts were taken by Muslim scholars who are knowledgeable in Islamic *fiqh* (law), economy and banking system, to establish Islamic banking system which will meet the need of Muslims who do not want to take or give loan for interest (Nasir, M. et al, 2008). Because of continuous collective efforts of Muslim scholars, the governments of different Muslim countries gave them permission to establish Islamic banks in different countries. As a result many Islamic banks were established in 1970s and 1980s (Rammal, 2007) in different countries in the world. Dubai Islamic Bank was established in 1975, Faisal Islamic Bank in Egypt was established in 1977, United Arab Emirates Islamic Investment Company Limited was established in 1978, Kuwait Finance House was established in 1979,

Bahrain Islamic Bank was established in 1979 Qatar Islamic Bank was established in 1981, Bank Islam Malaysia was established in 1983 and many more Islamic banks were established during 1970s to 1980s (Nasir, M. et al, 2008). These banks are the first Islamic banks which started banking transactions based on shariah (Naser, K. et al, 1997). According to Siddiqi, Islamic banking is founded mainly on the prohibition of *riba*. The main aim of Islamic banking and finance to provide an Islamic alternative to the conventional system that is based on *riba*. As an alternative to *riba*, the profit and loss sharing arrangement are held as an ideal model of financing in Islamic finance (Siddiqi, 2001).

It is expected that profit and loss sharing mechanism in Islamic finance will significantly remove the inequitable distribution of income and wealth and may lead to a more efficient and optimal allocation of resources as compared to the interest-based system. Thus, it will ensure justice between the parties involved as the return to the bank on finance is dependent on the operational results of the entrepreneur (Siddiqi, 2001). Islamic banking and finance as an alternative industry to conventional banking and finance is growing at a very rapid rate. Currently, there are about 2070 Islamic banks worldwide with a market capitalization more than US\$13 billion. The total assets of Islamic banks worldwide are estimated at more than US\$265 billion and financial investments are above US\$400 billion. Islamic bank deposits are estimated at over US\$202 billion worldwide with an average growth of between 10 and 20 percent. As regards Islamic bonds are currently estimated at around US\$30 billion. In addition, Islamic equity funds are estimated at more than US\$3.3 billion worldwide with a growth of more than 25 percent over past seven years and the global Takaful premium is estimated at around US\$ 2 billion (Rahman, 2007).

Some Islamic scholars hold that the early idealistic vision of Islamic banking and finance known as *maqasid al-shariah* (Objectives of Islamic law) has changed significantly (Saeed, 2004). The idealist approach seeks to maintain the relevant contracts that were developed in the shariah in the classical period. There are some opposing scholars who argue that the term *riba* does not include modern bank interest (Rahman, 2007:124). Instead of such comment by some of the scholars, Rahman (2007) emphasizes that the Islamic banking and financial industry must internalize both the objectives (*maqasid*) of shariah and the axioms of Islamic economics. The coming together of the different views, and more importantly, the resolving of them – the bridging of the identified ‘gap’ of ideals and realities – are essential next steps for the development of a more globally harmonized Islamic banking and finance industry that would better serve the society.

The objective of this research as stated in the abstract is to analyze Islamic financial transactions as viable alternative to conventional interest-based financial transactions with an intention to comply with the *maqasid al-shariah* (the objectives of Islamic law). Descriptive and analytical research methodology has been used in this research to analyze the collected data. The outcome of the interview from the focus group has also been explained in this research.

Prohibition on Interest (Riba)

Literally *riba* means excess, expansion, surplus, growth and increase. According to Shari’ah, a surplus of commodity or an excess in return without counter value is *riba* (Zuhaily, 2005). General point of view, *riba* is predetermined excess or surplus over and above the loan received by the creditor conditionally in relation to a specified time period. *Riba* was forbidden in the 8th or 9th year after the Hijrah (Arabic century).

The religion of Islam has strictly prohibited interest (*riba*) on loan given and instead has encouraged giving of *qard al-hasan* to needy people. *Shariah* has stated that taking interest on loan given is one of the greatest sins. Simultaneously, *shariah* has encouraged people to do business by investing the surplus money (Surah Baqarh, verse 275). The profit arises out of business is *halal*, it is not *riba*. So, Muslims can invest surplus money in business to gain profit (Ghannadian et al, 2004). If they give loan to needy people, they cannot take fixed rate interest on the loan given, they can give the poor or needy people the money as *qard al-hasan* (interest free loan). Allah has encouraged people to give *qard al-hasan* to needy people. *Shariah* (Islamic legal system) encourages Muslims to give *sadaqah* (charity, alms) and *qard al-hasan* to needy and poor people in society with an intention to help them in meeting their basic needs of life. Allah has promised reward for *sadaqah* and *qard al-hasan*. There are 12 verses in the Quran dealing with *riba*. First of all we have the six verses in the second chapter of the holy Quran in surah *al-Baqarah*.¹ Those six verses are as follows:

“Those who swallow usury cannot rise up save as he arises whom the devil has prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permits trading and forbids usury. He unto whom an admonition from his Lord comes and (he) refrains (in obedience thereto), he will keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returns (to usury)--Such are rightful owners of the Fire. They will abide therein. Allah has blighted usury and made almsgiving fruitful. Allah loves not the impious and guilty. Lo! Those who believe and do good works and establish worship and pay the poor-due (zakah or charity) their reward is with their Lord and there shall no fear come upon them, neither shall they grieve. O you who believe! Observe your duty to Allah and give up what remains due to you) from usury, if you are (in truth) believers. And if you do not, then be warned of war (against you) from Allah and His messenger. And if you repent, then you have your principal (without interest). Wrong not and you shall not be wronged. And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that you remit the debt as alms. That would be better for you if you understand.” (Surah Baqara, verse 175-180).

The last verse on riba in sequence, which was revealed in chapter thirty in surah al-Rum which reads:

“That which you give in usury in order that it may increase on (other) people’s property has no increase with Allah; but that which you give in charity, seeking Allah’s countenance, has increase manifold.” (Surah Rum, verse 39).

In the above verse Allah is encouraging giving charity instead of giving loan and taking interest (riba) on the loan given (Siddiqi, 2004:37). According to Siddiqi, (2004), interest taken on loan given to poor people, rich people or the businessmen, all are prohibited in shariah. The 12 Quranic verses provided in the Quran do not directly provide any reason why ribah (interest) has been made prohibited. However, if we ponder on those verses we may find the following reasons for prohibiting riba (interest). They are:

- a) *Riba* corrupts society.
- b) *Riba* implies improper appropriation of other people’s property.
- c) *Riba*’s ultimate effect is negative growth.
- d) *Riba* demeans and diminishes human personality.
- e) *Riba* is unjust (Siddiqi, 2004:37).

According to Pickthal and Siddiqi, charging interest on loan given is *fasad* (corruption). This charging of interest on loan is one of the wrong behaviours and it corrupts the society (Pickthal, 1992; Siddiqi, 2004:42). The second reason for prohibiting *riba* is that it amounts to unlawful appropriation of other people’s property is indicated in the verse from chapter four of the Quran in *sura al-Nisa*’ (Surah Nisa, verse 161). In that verse the Jews are admonished for ‘taking usury when they were forbidden it, and of their devouring people’s wealth by false pretences’. There lies a hint as to a generic connection between *riba* and *akl bi’l batil*. Significantly, Quran relates the tendency to appropriate other people’s wealth without any justification to some more serious crimes. Considering the serious dimensions of *fasad* and *akl bil-batil* to which *riba* has been related, the message seems to be: ‘charging interest belongs to a mind-set that leads to disruption of civil society’.

According to Siddiqi, The third reason is implied in the declaration that *riba* is subject to destruction [*mahq*] (Surah Baqara, verse 276) which means decrease after decrease, a continuous process of diminishing. It sounds a little odd as it runs counter to the commonly observed fact of people becoming rich by lending money on interest. Once we leave out the improbable interpretation of individual wealth amassed through *riba* business being subject to continuous decrease, we have to turn to the social wealth. *Riba*, even when it is increasing in numerical terms, fails to spur growth in social wealth. That role is played by charitable giving mentioned in the next half of the verse 276 in surah Baqara. Charitable giving transfers purchasing power to the poor and the needy that spend it. The destination of interest is not that certain. The fourth reason behind prohibition of *riba* is inferred from verse 2:275. This verse draws a picture of ‘those who devour usury’ as well as states the reason why they got into that pitiable mould. That reason is their being trapped into a false economics that equates trade—the act of selling and buying - with the practice of charging interest.

We would also like to note that some scholars think the picture painted of the one who takes *riba* belongs to the Day of Judgment, in the hereafter, not in this world. But that still leaves the main question unanswered: what is so wrong about taking interest to deserve that fate? The answer to that question has to be in line with the cause given in the later part of the verse itself: 'That is because they say: Trade is just like usury'. It is obvious that the cause lies in the behavior arising from the mindset revealed by that saying, not in the mere act of saying. If that is so, the behavior should show its effect in this world too. It is, therefore, better not to confine the picture to the hereafter. Let it cover both the personality of the *riba*-eater in this life on earth as well as his/her condition on rising from the grave in the afterlife to face the Day of Judgment (Al-Misri, 1991:42).

The fifth important reason of prohibiting *riba* is its being unjust, as the verse 2: 279 implies. This verse clearly states that taking an amount in excess of the principal would be unfair, unjust. It also recognizes the right of the lender/creditor to the principal without any decrease as that too would be unfair, unjust. The Quran does not argue further as to why it is unfair to take an excess in case of loan. Presumably it relies on the notions of equality and reciprocity inherent in the concept of justice. The unacceptability of injustice and unfairness was never in dispute between the Quran and its audience. It continues to be so in the modern times. What is not acceptable to many is the Quran's stand that taking any thing in excess of the principal amounts to injustice. To resolve this dispute we have to turn back to the difference between trade and interest-based transactions. That was the nucleus of contention between Makkan traders opposing the Islamic injunction and the Prophet, as reported in verse 2: 275.

The difference of 'riba' and 'trade' is that in trade there is a possibility and occurrence of losses. In other words we can say trade faces uncertainty in profit. That implies that even the recovery of the capital invested in trade is not assured. A *riba* contract, on the other hand, ensures the recovery of capital and seeks a positive return which is a fixed rate interest. Another fact should not be ignored is that profits are not predetermined as regards their size, unlike interest whose size is predetermined and is part of the contract. Even when a contract provides for a variable rate of interest, it is different from profit in trade that is not at all amenable to contracting. Some people ignore the fact that in trade both parties to the transaction proceed on the basis of some definite advantage perceived by each one of them, which advantages are available then and there at the time of the contract. But this cannot apply to an exchange of present money for money to be paid in future, as happens in a loan transaction. The reason lies in the nature of money as distinct from other goods and services. In other words, there is always a counter value to profit in trade whereas there is no counter value to interest.

According to Chapra (2000), conventional banking system is creating unequal distribution of capital (Chapra, 2000). He says, it would be a great advantage if the interest-based financial intermediation is replaced by the profit and loss sharing system. The established practice of banks in the conventional banking system is to lend mainly to those individuals and firms who have the necessary collateral to offer large internal savings to service the debt. Credit therefore, tends to go to those who, according to Lester Thurow, are 'lucky rather than smart or meritocratic' (Thurow, 1980:175). The banking system thus tends to reinforce the unequal distribution of capital (Bigsten, 1987:156).

Islamic Banking: Concept and Nature

Prior to the advent of Islam in Saudi Arabia, Islamic banking and financial system which was interest free financing was followed and practiced by some of the Arab traders and others followed interest based financing system. Later when Arabs became Muslims, they accepted this interest free financing in their trade activities. Arabs used this interest free financing system for centuries (Rammal, et al, 2007). The Islamic bank invests money in business based on *shariah* principle of profit-loss sharing mechanism.

It invests money in business in *musharakah* or *mudarabah* transaction and share profits on pre-determined ratio. If there is loss it also shares loss on pre-determined ratio. The Islamic bank does not take interest (*riba*) as interest is prohibited in Islam.

Riba means increase, addition, excess etc. as stated earlier. When a person lends money to others and takes fixed rate interest on it, this interest is prohibited in Islam (Salleh, 1988; Saeed, 1996; Khan, 2002). For example, Mr. X lends RM 2000 to Mr. Y on condition that the loan is for one year and Y has to pay 10 % annual interest on the loan amount.

After the expiry of twelve months Y must pay the capital sum RM 2000 plus the fixed rate interest RM 200. This RM 200 is considered as *riba* and it is strictly prohibited in *shariah*. Allah (God) prohibits *riba* in al-Quran. Allah says, “Those who earn from usury stand only like one who is struck by the devil’s touch. That is because they claim that usury is a form of trade. But Allah permits trade, and prohibits usury. Whoever heeds this admonition from Allah, and abstains from usury, may keep his past earnings, and his judgment rests with Allah. As for those who return to usury, they will deserve hell, wherein they abide forever.” (Surah Baqara, verse 275).

The above verse of al-Quran clearly prohibits interest. In this verse Allah has permitted trade but prohibited interest. If we analyze this verse, we can understand that if someone has money, he can invest the money in business and if he gains some profit from there, he can keep it and enjoy it. The profit from business is not interest (El-Gamal, 2007; Thomas, 2006; Delorenzo, 2000). Allah has prohibited interest. What is interest then? Interest is the additional amount of money taken with the capital sum on loan transaction. For example, Mr. A lends money RM 1000 with 15% yearly interest. This 15% additional money claimed on the loan amount is interest and it is prohibited. The lender is allowed only to take the principal sum RM 1000 and not more than that. An example of profit in business is: Mr. A has invested RM 10,000 in business and has received RM 3000 profit after 30 days. This profit of RM 3000 after one month is not interest, it is profit from business and permitted to keep and enjoy in *shariah*. In the above verse Allah also says that taking interest on loan given is a great sin. If a person takes interest on loan given to another person, he will abide in hell in the hereafter as a punishment. The punishment is very serious. So, the practice of taking interest on loan should be abandoned.

As stated earlier Allah encourages people to give *qard al-hasan* (benevolent loan) to people who need money. *Qard al-hasan* means the lender just helps a needy person by giving loan but does not take any extra money other than the principal sum lent. This is to help other people who are in need of money. By giving *qard al-hasan* a person can get reward from Allah (s.w.t.) and can get gratitude from the borrower. The rationale for prohibiting interest is that it discourages wealthy people from giving *qard al-hasan* to people. It makes a person greedy for interest and does not encourage a wealthy person to help poor people in the society by giving financial loan without interest. Another reason of prohibiting interest is that when the borrower fails to pay the loan and interest on time, the lender oppresses him mentally and sometimes takes away his property and sells it to customers to get back his loan amount plus interest from the sale proceeds. So, interest may cause oppression on borrower and make the heart of lender harder. The greed for interest will not encourage a person to give *sadaqah* (charity) to poor people or for charitable purposes (CIIP, 1991; Zamir, 1995; Ahmad, 1984; Abu Saud, 1983).

Another reason for prohibiting interest on loan is that the lender does not take any risk from the loan. He gets increase in his money without taking any risk of loss. Interest based loan has no risk for loss. On the other hand, when he invests the money in business he takes the risk of loss, because he is not sure whether he will get profit or loss. Therefore, in business there is a possibility for loss but in interest based loan there is no such possibility. In another two verses Allah says, “O you who believe! Fear Allah and give up what remains of your demand for usury, if you are indeed believers. If you do not do it, take notice of war from Allah and His messenger; but if you turn back, you shall have your capital sums; deal not unjustly and you shall not be dealt with unjustly.” (Surah Baqara, verse 278-279).

The above verse specifically orders the people who are taking interest on loan given to stop taking it. They can only get back their capital sum which is given as loan and not the interest, because interest has been prohibited in the earlier verse 275. Allah warns the people who are engaged in interest practice to stop taking interest unless Allah and His messenger will wage war against them. Declaring war against the people who are practicing *riba* (interest) indicates the seriousness of the prohibition of *riba*. After the death of Prophet Muhammad (peace be upon him), it is the duty of his successors and the governments of Muslim countries to wage this war against the people who are involved in *riba* practice. Here, waging war means fighting against the lenders who take *riba* and punishing them if they do not stop taking interest on loan given.

Allah says in verse 279 of Surah Baqara, “Deal not deal unjustly and you shall not be dealt with unjustly.” What Allah means by the words “deal not unjustly”? As we understand from the ruling Allah is saying that taking interest on loan given is tantamount to dealing unjustly with the borrower, in most of the cases the borrower spends the money in meeting personal needs and becomes unable to pay back the loan.

As a result, the lender put pressure on him to pay back the capital and interest; sometimes he takes away the borrower's valuable property and sells it to get his loan and interest from the sale proceeds. Thus, injustice is caused to the borrower in interest based loan financing as practiced during the prophet Muhammad's time and before his birth in Arab lands. Like al-Quran, hadis² also has prohibited *riba*. In a hadis prophet Muhammad (s.a.w.s.) has said, "Any loan that gives benefit to the lender is *riba*." This *hadis* defines what *riba* is and what is not *riba*. When a lender of money gets benefit from the loan, that benefit is *riba* (interest). So, the lender cannot take any benefit out of the loan given. What is the benefit here? The benefit might be the lender asks the borrower to pay some extra money other than the loan amount given to him or the lender asks the borrower to give him any other benefit for example to do some work for the lender without any payment.

However, if a person invests his money in business for example in *mudarabah* transaction and shares part of the profit from that business, the profit is not interest but it is profit and the *sahibul maal* (the owner of capital) is allowed to take it. In *mudarabah* transaction one person agrees to provide capital (capital provider) and the other person agrees to do business with the money (entrepreneur). If there is any profit from the business, it will be shared among them and if there is any loss it will also be shared among them as agreed between them on the ratio. In another hadis (the saying of prophet Muhammad) prophet Muhammad (peace be upon him) has prohibited taking *riba* on loan given to others and said it is one of the great sins. He says, "Allah has cursed the receiver, the giver, the witness and the writer of *riba* (interest) and it is amongst the great sins." (Hadis Book Sahih Muslim).

In the above hadis prophet Muhammad (peace be upon him) said that Allah's curse will be on them who takes interest, who gives interest, the person who records interest transactions and the witness of interest transaction. So, four types of persons might be involved in interest transactions and all of them will be punished by Allah in the hereafter for practicing or being involved in *riba* transaction. In the above *hadith* the prophet also says that it is a great sin to be involved in interest transaction.

According to Ahmad, Khurshid (2000), it is a characteristic of Islamic banking is that Islam wants the economy, its major monetary and business dealings, to move from a debt-based relationship to an equity-based and stake-taking economy. While there is scope for some debt-based transactions on the principle of *qard al-hasan*, the overall thrust of the economy would be towards equity-based and risk-sharing arrangements. This is a revolutionary change as it calls for a new psychology and a new approach to the economy. It demands that all the major actors within the economy participate in the productive system and does not allow some to become a rentier class (Ahmad, 2000).

Financial Transactions in Islamic Banking

In our previous discussion we have stated that Islamic banks operate financial transactions based on profit-loss sharing mechanism which does not involve taking and giving interest. Conventional banks are unlike Islamic banks, offer financial debt based on interest which is strictly prohibited in Islam. As-*shariah* (the Islamic law) has prohibited interest on loan but permitted business. The Islamic bank invests its finance to business activities based on certain financial transactions which *shariah* has approved. Those financial transactions are: *wadiah*, *mudarabah*, *musharakah*, *murabahah*, *bai bisaman ajil*, *bai salam*, *ijarah*, *bai al-tajiri*, *ujrah*, *wakalah*, *al-qardul hasan*, *bai istisna*, *ar-rahnu*, *kafala* etc. These *shariah* based financial transactions are briefly explained below.

Al-wadiah

In *al-wadiah* transaction, people keep money with the Islamic bank. It is known as deposit. The deposit can be in savings account, current account, fixed deposit account etc. The depositors of money by contract allow the bank to invest the money in business. If there is some profit, it is distributed among the depositors based on the proportion of money deposited (CERT, 2006). In *al-wadiah* transaction, the bank acts as the agent of the depositor. The bank is given full freedom to utilize the money without prior consultation with the depositor.

Mudarabah

This is a type of transaction whereby one person provides capital for business and another person agrees to provide business skill to invest the money in business. So, one party provides capital and other party does business with the capital. The person provides capital is known as *sahibul maal* and the person does business with the money is known as *mudarib* (entrepreneur).

The capital provider and the entrepreneur share profits and loss in the business based on agreed ratio. In *mudarah* transaction the capital provider does not participate in the business management but he supervises the business time to time by giving instructions to the *mudarib* (entrepreneur) (Nik Norzul et al, 2003).

The fixed deposit money or investment money in the bank can be reinvested in business under *mudarah* transaction where the bank will act as *mudarib* and the clients who have invested the money to the bank act as *sahibul maal*. If there is profit, it will be divided among the *sahibul maal* and the *mudarib* in ratio agreed by them (Siddiqi, 1983).

According to Talib, Murabahah financial transaction is also known as ‘bai bisaman ajil’ (BBA). It involves the sale of goods (usually merchandise and equipment) by the bank to its client at a price that includes a profit margin mutually agreed upon. The consideration is paid by installments over a period of time. Since the bank takes title to the goods before reselling them and it is engaged in buying and selling, its profit derives from a real service that entail a minimal risk. In murabahah contract, the price, other costs and the profit margin of the bank are stated in the agreement of sale (Talib, 1987). Islamic banks which are engaged in murabahah transaction aver that it is not ‘purely financial’ transaction whereby a borrower-entrepreneur receives liquidity from a bank, but it involves a receipt of real assets and as such a predetermined positive return is allowed (Talib, 1987:48; Ahmad, 1987:75; Man, 1991:239).

Musharakah

In *musharakah* (partnership) transaction, two or more persons provide capital for business and they share the profit or loss based on the portion of capital provided. It is not necessary that all partners should participate directly in the management of the business. Some of the partners can actively take part in the management of the business and other partners may remain as sleeping partners.

The sleeping partners may supervise the business activities from time to time and can provide instructions to the active partners to conduct business effectively and efficiently. They also can follow-up the progress in business without being actively involved in the business management. The partners who actively participate in the business management are usually paid monthly salary other than profit in the business. Islamic bank can take part in *musharakah* business by investing some of its equity capital. The word *musharakah* also includes company business. By investing money in partnership or company, Islamic banks can earn profit. This profit is not interest in *shariah* and Islamic banks are allowed to keep it. The profits in *musharakah* business are income from business and not interest on loan given. Therefore, it is a *shariah* approved transaction (Butterworths, 1988).

Musharakah can be a good business mechanism as it allows the business to collect large amount of capital to do large business. In *musharakah*, there are many partners who contribute their capital for doing business. Similarly, in company business there are many shareholders who contribute the value of their shares. Thus, the partnership or company may have a large capital to conduct large business. Large businesses have the possibility of earning a large amount of profit. Therefore, the partners or shareholders have an opportunity to get high amount of dividend from the profit earned by the partnership or the company.

Murabahah

In *murabahah* transaction, Islamic bank buys goods or real property in accordance with the specifications of the customer and sells it to the customer with a mark-up profit. This is not interest transaction as the bank is not giving loan to the customer. It is just selling goods to the customer with profit. The customer is given an option either to pay in one lump sum or by installments (Ahmed, 1989; Khan, 1992). In this sense *murabahah* is like *bai bisaman ajil*.

An example of *murabahah* transaction is: Mr. X wants to buy a Proton Waja car but he does not have cash money. He approaches to the Islamic bank to buy the car. The Islamic bank will ask the customer (Mr. X) to provide with detailed specifications of the car, year, colour, automatic or manual, maximum price etc. The Islamic bank will make a contract with the customer that it will buy the car and sell to the customer with a mark-up profit and the customer will be given an opportunity to pay by installments for a fixed period say five or ten years. When this contract is signed by the customer, the Islamic bank will buy the car in accordance with the specifications provided and sell it to the customer with installment facilities.

Murabahah financing does not involve interest and it is acceptable by shariah (Islamic law) principles. According to Siddiqi and Khan, there is no injustice involved in murabahah-financing insofar as the relationship between the financier and the entrepreneur-buyer-on-credit is concerned. On that count it is superior to the financing arrangement based on interest. The financier is financing not a venture of uncertain results but the acquisition of a commodity of acknowledged utility and known current price. The mark-up on current price is tacked on the commodity, whereas in interest-based borrowing it is tacked on money capital (the principal). By converting its money capital into a commodity the financier has already given up liquidity and taken the risks associated with owning a real asset, e.g. a fall in its market price, destruction due to natural causes or theft, etc. He/she also takes the risks associated with relying on the other party's promise to buy, it is like taking the risk of bankruptcy of the would-be buyer or backing down on its promise to buy. Also, by selling on credit the financier is taking the risk of default by the buyer as well as forgoing any other opportunities of using the money that could have arisen as time passes. Time, which is not recognized by shariah (Islamic law) as a basis of claiming an excess over principal when making a money loan, becomes part of the justification for a mark-up in credit sale (Khan, 1995:160).

Bai Bisaman Ajil

In *bai bisaman ajil* transaction, Islamic bank sells goods or real property to a customer with deferred payment facility usually by installments. So, in *bai bisaman ajil* transaction the buyer gets delivery of goods immediately but pays the price in future as a lump sum or by installments. *Bai bisaman ajil* helps a buyer to procure goods he needs when he does not have the cash to buy it. Thus, this kind of transaction is very much beneficial to a buyer who does not have cash money (Cizaka, 1995; Rosley, 2005).

Bai Salam

In *bai salam* transaction, Islamic bank may buy certain goods from a seller with a condition that the payment should be made immediately but the delivery of the goods would be made in future. As payment is made in advance, the buyer can buy the goods with cheaper price. So, he can make profit by selling the goods after its delivery under the *bai salam* contract (Nasir, M. et al, 2008). Islamic bank may make another contract after making the *bai salam* contract which is known as parallel *salam* contract. In parallel *salam* contract, the Islamic bank may make a parallel contract with another buyer to sell the goods it is going to buy in future under the *bai salam* contract.

Ijarah

Ijarah transaction is known as rental or lease contract. In *ijarah* transaction the owner of a good (lessor) rents the goods to another person for payment. The other person is known as hirer or lessee. So, there are two parties in this transaction known as the owner of goods (lessor) and the hirer (lessee). The hirer hires the goods for a specific period for a fixed rental. The rental is paid daily, weekly or monthly basis as agreed by the parties. In *ijarah* transaction, the hirer can enjoy and get benefit from the rented goods or real property without having to buy it for cash. *Ijarah* is equivalent to lease and similar to conventional financial lease (Gambling et al, 1991; Ismail et al, 1998). In *ijarah* transaction, the ownership of the goods does not pass to the hirer. The owner of the goods retains the ownership; he only gives possession of the goods to the hirer and also gives right to the hirer to use the goods for his benefit for a fixed period and for periodical rental as agreed between the parties.

The hirer probably can have insurance policy on the goods in his own name as he has some interest in the goods as a hirer; the best thing is to insure the goods in both the owner and hirer's name to be safe from unwanted legal consequences.

Ijarah Muntahia Bittamlik

Ijarah muntahia bittamlik is also known as *bai al-tajiri*, *ijarah summa al-bai* and *kiraa waqtina*. *Ijarah muntahia bittamlik* is a hire-purchase contract. In this type of transaction the hirer hires goods or real property for periodical rents and at the end of rental period he has an option to buy the goods. In *ijarah muntahia bittamlik*, the ownership in the goods initially does not pass to the hirer; the ownership only passes when the goods are sold to the hirer at the end of the hired period or any time during the hired period. When the goods are sold to the hirer, the sale should be evidenced in a separate sale contract.

The selling price will be determined by agreement between the parties. However, the owner of the goods may give the goods to the hirer as a gift (*hiba*) under *aqd al-hiba* (Haq, 2002).

Ujrah

Ujrah is a service providing contract whereby an agreement is made between two parties. One party agrees to provide certain services (known as service provider) to other party and the other party (known as service receiver) agrees to pay for the services provided. The contract must specify the nature of the services provided, how long it will be provided and how much royalty to be paid for the services. Islamic banks may make an *ujrah* contract to provide some services to another person for payment (Nasir, M. et al, 2008).

Al-qardul Hasan

Al-qardul hasan is benevolent loan given to a needy person for a fixed period of time. *Shariah* prohibits taking interest or any other benefit from loan given. It encourages people to give *qard al-hasan* to a needy person with an intention to help them. In the society we live in we should help each other without taking any wage or exchange for the help. It is known as benevolent help. *Qard al-hasn* is a type of benevolent loan designed to help a neighbour or relative for a fixed period of time (Wordiq, online, n.d.).

At the end of the period predetermined for the loan, the borrower must return the loan amount to the lender. The lender cannot ask for any extra money (known as interest) for the loan, he can claim back only the principal amount lent and nothing else. However, if the borrower gives a reward to the lender being happy with him for the help, probably the lender can receive it. Allah has promised to give reward to the lender of *qard al-hasan* in the hereafter, because the lender gives such loan only to please Him and with an expectation of receiving an award from Him in the hereafter. Islamic bank offers *qard al-hasan* to needy people in the society without any benefit. However, Islamic bank is allowed to take a service fee for record maintaining and collection of the benevolent loan.

Wakalah

Wakalah is an agency contract between the principal and the agent. The principal is known as *muakkil* and the agent is known as *wakil*. In *wakala* contract, the *wakil* agrees to perform a certain act on behalf of the *muwakkil* for payment as agreed by the parties. Both the parties in agency contract must have capacity to make a contract. If both of them are of sound mind and have attained the age of 15,³ are capable of making a valid agency contract. Under a *wakala* contract the *wakil* is required to abide by all the instructions given by the *muwakkil* while performing his duty, unless the *wakil* will be responsible for any resulting loss to the *muakkil* (Nasir, M., 2008). Islamic bank can act as a *wakil* under a *wakala* contract to do an act for the *muakkil* or the Islamic bank can appoint a *wakil* to have its work done by him. *Wakala* contract is valid in Islam as *riba* or *gharar* is not present in this type of contract.

Ar-Rahnu

Ar-rahnu is known as charge or pledge or mortgage. In *ar-rahnu*, borrower of money puts his valuable property such as land, building, gold jewellery etc. as charge to secure the loan he takes from an Islamic bank. Islamic banks cannot provide conclude murabahah or bai istisna contract or *qard al-hasan* without securing the loan with a valuable property of the borrower because now-a-days people are not trustful.

They are negligent to pay back the loan given as *qard al-hasan*. *Ar-rahnu* on valuable property of a borrower provides security and peace of mind of Islamic bank managers in case the borrower fails to pay the loan on time (IDB, 2001). There are two parties in *ar-rahnu* contract. The chargor and the chargee. The person who charges his valuable property as security for loan is called chargor (borrower of money) and the person who takes the valuable property as charge (*rahnu*) to secure the loan given is called chargee (Islamic bank) (Chan et al, 2010:372). If the chargor fails to pay the benevolent loan or credit, the chargee has right in law to take possession and sell the charged property to a third party for market price. From the value of the property sold, the chargee can take full amount of benevolent loan or credit due and if there is any extra money left, he must pay to the chargor.

Kafala

Kafala means guarantee. It is an alternative to *ar-rahnu*. Islamic bank can provide *qard al-hasan* or credit facility to someone if another person becomes a guarantor for the loan or the credit. The guarantor provides guarantee that in case the borrower of money or the debtor fails to pay the sum due, the guarantor will pay the amount due to the lender or the creditor (Nasir, M., 2008). So, *kafala* works as security for loan or credit given to a person or a business enterprise. Now-a-days people are not sincere enough to pay back the loan or credit amount to the lender or the creditor. Therefore, the lender or the creditor wants guarantor for the loan or credit facility offered.

Bai Istisna

Bai istisna is known as order sale. Islamic bank can accept orders to construct building or produce goods for a customer. When the building is built or goods are manufactured, they are sold to the customer with a profit. The customer is given credit facility. The customer can pay by installments for a fixed period of time say 10 years (Wardi, 2000). For example, a person wants to construct 12 floors residential building on his land but he does not have enough money to construct the building. The person can approach to an Islamic bank and can place an order to construct the proposed building.

Islamic bank will accept the order and will prepare a detailed agreement where specifications and descriptions of the building, the promise of the customer to buy the building after it is erected, payment of installments, period of payment etc. should be written. Then the agreement is signed by the both the parties and also the customer promises to charge the building or other valuable property as security for the credit facility given to him. The agreement may also provide the consequential remedies for any breach of the agreement or not complying with the specification or condition in the agreement (Wardi, 2000).

When the building is fully constructed, the Islamic bank will sell the building to the customer (who placed the order to construct the building) with a profit. In this *bai istisna* transaction *riba* is not involved. So, it is a valid transaction under *shariah*. In *bai istisna* transaction, both the customer and Islamic banks are benefited. The customer may not have enough cash money to construct a building or to buy required goods for business. So, he gets the building or the goods from an Islamic bank with credit facility. On the other hand, the Islamic bank by supplying the goods ordered or by constructing the building ordered and later by selling it to the customer, gains some profit. Therefore, *bai istisna* is an important *shariah* approved transaction that can be undertaken by Islamic banks.

Regulatory Framework of Islamic Banking

It is pertinent to have regulatory framework for banking industries. There is regulatory framework for conventional banks in every country in the world. Every bank either conventional or Islamic, must have a strong regulatory framework. The function of the regulatory framework is to make sure that the bank complies with all legislative laws related to banking and finance and must not commit any fraud or illegal acts. In Malaysia, there is Banking and Financial Institutions Act 1989 which provides regulatory framework to regulate and ensure smooth running of conventional banking system. Similarly, there must have a regulatory framework for Islamic banks to regulate its activities. Malaysian government has enacted Islamic Banking Act 1983 to regulate activities of Islamic banks in Malaysia and to make sure that Islamic banks comply with all the provisions in this Act. This Act provides many regulatory provisions for Islamic banks inter alia that Islamic banks must not involve in interest based transactions or haram (prohibited) transactions. Haram transaction means Islamic banks cannot invest money to do business of haram (prohibited) things such as wine, heroin, cannabis, pig meat, gambling etc. The Central Bank of Malaysia has also power to regulate the activities of Islamic banks in Malaysia. Public Islamic banks are required to list with Stock Exchange (Bursa Malaysia)

So, far there is no similar laws made by the government of Bangladesh to regulate financial activities of Islamic banks in Bangladesh. Currently Islamic banks in Bangladesh are fully complying with the guidelines made by the Central Bank of Bangladesh related to Islamic banking and finance. Among the Islamic Banks in Bangladesh 'Islami Bank Bangladesh Limited' is fully complying with all relevant legislations and the guidelines of the Central Bank of Bangladesh and performing excellent in financing capital in the capital market of Bangladesh.

As Islami Bank Bangladesh Limited is complying with all the relevant laws and guidelines in Bangladesh and complying with shariah (Islamic law) requirements, it has been selected as the best Islamic banks for many years since 1999 to 2010. Global Finance in the US has selected Islami Bank Bangladesh Limited as the best Islamic bank in Bangladesh in the year 2010. President Mr. Joseph D. Giarputo gave away a prize to the bank on 9 October 2010 for its best performance in the Islamic financial market. The prize was given away in a prestigious program held in National Press Club at Washington DC in the United States. The chiefs and representatives of the best banks and financial institutions attended in this program. Important mass media including the Voice of America broadcasted this news with much importance. (Sangram, 16 October 2010). This type of prize is given to those Islamic banks which are contributing in the development and increase of Islamic finance, able to reach shariah compliant products to its clients and building foundation for rapid development in Islamic banking and finance in future. Global Finance also selected Islami Bank Bangladesh as the best Islamic bank in Bangladesh in 1999, 2000, 2004, 2005, 2008 and 2009 (sangram, 16 October, 2010).

The legislations on Islamic banking and finance in almost every country in the world require each and every Islamic banking and financial institutions to have their own Shariah Board. This Shariah Board consists of 10 to 15 prominent Islamic scholars in the respective country of the bank. These Islamic scholars are well-versed in Islamic banking law. The Shariah Board plays an important role in controlling the standard of an Islamic bank. It also requires the Islamic bank to comply with shariah requirements in all financial products which the bank is dealing in. Without the approval of the Shariah Board no Islamic bank can offer a financial product in the market. So, the Shariah Board is given very high and wide power to control the functioning of the bank in compliance with shariah.

We have seen above that there is Parliamentary legislation in Malaysia to control the Islamic banking and financial system in Malaysia, but unfortunately Bangladesh government has far not made any such Parliamentary legislation in Bangladesh to control the Islamic banking business in Bangladesh (Rahman, 2010). Bangladesh Bank recently introduced the 'Guidelines for Islamic Banking'. Bangladesh Bank is known as the Central Bank of Bangladesh. The Central Bank of Bangladesh stated that as Islamic banking had become a part of mainstream banking in Bangladesh, it had become necessary to introduce the guidelines to bring greater transparency and accountability in the Islamic banking in Bangladesh. It is a delayed and inadequate step for the Central Bank to introduce the guidelines.

The Central Bank of Bangladesh took very long time to formulate the guidelines though Islamic banking in Bangladesh began long ago. Bangladesh which ratified the Islamic Development Bank (IDB) Charter in 1974 is committed to restructure its economy and banking system in phases. The Foreign Ministers of the OIC countries including Bangladesh approved the definition of Islamic banking in Dakar in 1978.

President Ziaur Rahman was the pioneer in establishing and developing Islamic banking and finance in Bangladesh. In 1981 an OIC summit was held in the cities of Makkah and Tayef. In this summit President Ziaur Rahman of Bangladesh stated, "The Islamic countries should develop a separate banking system of their own in order to facilitate their trade and commerce." It was in this backdrop that the Finance Ministry sent a letter to Bangladesh Bank with the request to ask all state-owned commercial banks to introduce, on experimental basis, separate Islamic banking counters with separate ledgers in all their branches (Rahman, 2010). The Islami Bank Bangladesh Limited started its operation in March 1983. Since then Islamic banking made a gradual but steady headway in Bangladesh. All the governments in Bangladesh backed the system. Now Bangladesh has seven full-fledged Islamic banks. Besides, 11 other commercial banks opened their Islamic banking windows. Of late, three giant state-owned banks, Sonali Bank Limited, Agrani Bank Limited and Janata Bank Limited are preparing to open their Islamic banking windows.

As said earlier despite the growth of the Islamic banking, Bangladesh has no law to deal with the system. In the absence of a comprehensive law, Islamic banking service and products are growing well but it is not strictly regulated as per shariah (Islamic law) compliance. Despite some shortcomings and limitations, the guidelines made for Islamic banks in Bangladesh in 2008 would remain a milestone for Islamic banking. Though the guidelines do not cover all aspects of operation and management of Islamic banking, it would provide the basic direction for Islamic banking in the country. The Central Bank of Bangladesh frankly acknowledged in the Appendix of the guidelines about the perceived short comings.

This Guideline does not address all aspects of Islamic shariah. So, reporting Institutions are required to follow the Shariah rules set by their respective Shariah Supervisory Committee as well as AAOIFI. A few prominent characteristics of the Guideline are enumerated below:

Bangladesh Bank stated that a 'Focus Group' comprising, Bangladesh Bank, different Islamic Banks and the Central Shariah Board for Islamic Banks of Bangladesh (CSBIB) had prepared the guidelines. It observed that the guidelines became necessary to ensure that activities of the fast growing Islamic banks are carried out 'properly and uniformly' according to the **principles** of Islamic Shariah. The Central Bank of Bangladesh constituted the 'Focus Group' to formulate 'integrated guidelines' for conducting banking business by Islamic banks as well as for conventional banks which are interested to open Islamic banking windows along with their conventional banking (Rahman, 2010).

Previously the law in Bangladesh allowed any banker without any experience in Islamic banking to become the CEO of an Islamic Bank. A number of Islamic banks appointed some bankers with no experience in Islamic banking as their CEOs. This clearly violates the maqasid al-shariah (the objectives of shariah), because Islamic law requires that the CEOs of Islamic banks and Islamic financial institutions must be knowledgeable in Islamic banking principles stated in the Quran and the hadis. As a result, they were unable to comply with Shariah principles relevant to Islamic banking. It affected the trust and confidence of the people in Islamic banking. The new guidelines have plugged the hole. The guidelines require a CEO to be a professional banker with at least 3 years' experience in Islamic banking. Such a minimum requirement is very much needed to ensure compliance with shariah principles. The new guidelines allow conventional banks to open Islamic banking windows adhering to Shariah principles.

Conclusion

As stated in the foregoing sub-topics, the religious book of Muslims known as the Quran has prohibited taking of interest on loan given to people. There are about 12 verses in the Quran which has strictly prohibited taking interest on loan transaction. Islamic religion considers taking interest on loan is a great sin for which the punishment is hell fire in the hereafter (Surah Baqara, verse 276). Prophet Muhammad also has prohibited taking interest in many hadis. Therefore, Muslim scholars did research how to convert conventional banking system into Islamic banking system which would not be based on interest.

The research work took long time as it is impossible to operate banks without taking interest or some payment from clients or debtors, because the bank has to pay rent for the office building, pay salary and other benefits to its employees, to pay dividend to its shareholders etc. In 1970s some Islamic scholars found some solutions to avoid interest on loan transactions in banking system. Hence, in 1970s and 1980s some Islamic banks were established in different countries in the Muslim world to operate based Islamic banking principles. There are more than 2000 branches of Islamic banks in the world. Some non-Muslims countries in the world have also established some Islamic banks (Jalaluddin, 2002). There are many conventional banks in the world which have opened Islamic banking windows in their thousands of branches worldwide. These Islamic banks are operating based on shariah (Islamic law) approved Islamic banking transactions which have been very briefly explained above.

The Islamic banks are doing very good compared to conventional banks in the world as it is based on universal principles of fairness, equity, honesty, piousness and profit-loss sharing mechanism. Conventional banks are facing moderate and major financial crisis for the last few decades but Islamic banks so far has not suffered from such financial crisis because of its praiseworthy Islamic principles of honesty, interest-free, profit-loss sharing mechanism etc. Some scholars say that there is bright future of Islamic banking system in solving capital market crisis in the world.

It is to be noted that Islamic banking and financial system still in its infancy. Long-term research and development is needed in this field to its further improvement and acceptability to people. Some Muslim scholars criticize some of the Islamic banking transactions which they say are interest based and borrowed from conventional banking systems. To solve these problems, continuous research and development is very much needed in developing more Islamic financial transactions which are not contradictory with maqasid al-shariah (the main principles of Islamic finance).

At present time, it is very important to have a universal system of banking and finance which will be fair, equitable, free of interest, free of fraud, ethical and viable for financial market. Islamic banking and finance has such bright future if the Islamic scholars are able to carry on their continuous research and development on this field to meet the needs of the present welfare society. Islamic scholars have to prove that Islamic banking and finance can be a viable alternative of conventional banking system.

Explanation

¹ In the Quran the word 'surah' has been used to mean chapter. So, 'Surah Baqarah' means 'Chapter on Baqarah'.

² Hadis is Arabic word which means 'the sayings, deeds and tacit approvals of prophet Muhammad'. In other words whatever prophet Muhammad said, did and tacitly approved of acts done by his companions during his lifetime are all known as hadis or sunnah of prophet Muhammad. There are six prominent hadis books which narrate thousands of hadis of Prophet Muhammad for example, Hadis Book Bukhari, Hadis Book Muslim etc.

³ Under the agency law and Age of Majority Act of Malaysia, the age of majority is 18 years.

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