Chapter 2
The Concept and Functioning of Islamic Banking System

2.1 Theoretical Models

The theoretical work on the concept of Islamic Banking is based on the basis that concept for all financial intermediaries in an Islamic society should be derived from the principles of Shari’ah (Islamic Law). The form and content of Islamic Banking practices have to be derived from the teaching of Islam. The theoretical model of Islamic Banking is based on the premise that interest, is neither a necessary nor a desirable basis for the management of banking operations, and that Islamic principles provide a better foundation for organizing the working of Banks.¹

The commitment of Islamic Banks to abide by Shari’ah (Islamic Law) influences to stipulate their main characteristics. These banks operate such as conventional banking to provide the banking services within the legal framework of their respective countries and under the supervision of their respective central banks. But Islamic Bank’s commitment to the Shari’ah (Islamic Law) is expressed in formulating its mode of operations and relationships with supplies and user of funds in order to make them in accordance with Shari’ah (Islamic Law).²

The Islamic Banking is a significant intermediary and vital institution in the economic structure of any country. It mobilizes savings and idle funds and makes them available to those who can make better and fuller use of them. The banking effects a reallocation and distribution of the capital funds.³ There is a need to transfer funds from savers to investors because people who save are generally not the professional people who have the

²Monzer Kahf, Islamic Banks at the Threshold of the Third Millennium (Jeddah: IRTI), p.5.
ability to exploit the profitable investment opportunities. Since the savers and investors are usually different units, they need a considerable amount of information about each other. This information is not free. Therefore, the process of channeling funds from savers to investors involves transactions cost. Consequently, the process of financial intermediation removes some mismatches in the tastes, maturity terms and size of needed funds between the two sides.4

The main principle of operation of all the Islamic Banking models is a two tier ‘Mudarabah’ contract, the first contract among the depositors and the bank, and the second between the bank and the parties to whom finance is provided, which based on the basis of Profit-sharing.5 The Mudarabah contract is the foundation of financial intermediation and thus of banking, under which financier provides capital and the Mudarib (labor partner) provides his technical know-how and skill and the profit is shared between the partners according to an agreed percentage.6 This is known as the principle of ‘al Mudarib u darib’ and it can be expressed as, ‘the one who mobilizes funds, on a profit sharing basis, extends these funds to the user on the same basis.’ In this way, the status of Islamic Banking in relation to its clients is that of partner, investor and trader, whereas in commercial banking in the West, the relationship is that of creditor or debtor.

The general conventional microeconomic model of bank can be classified into three types of balance sheet.

- The first kind focuses on the asset side of the banks.
- The second type emphasizes the liability side
- The third combines elements of both assets and liabilities.8

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5Ziauddin Ahmad, No.1, p.16.
How an Islamic Banking works? The models of banking have led to a variety of proposals that can be categorized into two principal models.

1. The First Model: Integrates Asset and Liability Side: Based on a principle called “the two-tier Mudarabah” on the concept of profit-sharing. This model leads the depositors entering into a contract with a banking firm to share the profits accruing to the bank’s business. The bank, on its asset side, enters into another contract with an agent-entrepreneur who is searching for available funds and who agrees to share his profit/loss with the bank in accordance with a predetermined percentage stipulated in the contract.

2. The Second Model: Only Liabilities Side: Liabilities side of the balance sheet divides into two windows, one for demand deposits (transaction balances) and the other for investment balance. This demand deposit requires a 100 percent reserve because these balances belonging to the depositors are placed as Amanah (safekeeping) and must be backed by 100 percent reserve and do not carry with them the innate right for the bank to use investment balance. Money deposited in investment accounts, on the other hand, is placed with depositor’s full knowledge that his deposits will be invested in risk-bearing projects; therefore, no guarantee is justified.

In addition, the banks utilize Islamic modes of financing on the each sides of the balance sheet as following.

- The Liabilities or Resource Mobilization Side: It mobilizes funds on the basis of a Mudarabah or Wakalah (agent) contract. On the resource mobilization, the Mudarabah, either general or restricted (to certain business line) is the mode most often used. The bank and the investment deposit holders share the realized profit

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in accordance with the ratios agreed upon between the parties at the time of agreement.

- **The Asset or Utilizing this Resources Side:** It advances funds on a profit-and-loss sharing or a debt-creating basis. It plays the role of an investment manager for the owner of time deposit. On the utilizing resources side, for income generation, Islamic banks use both fixed return modes such as Murabahah and leasing and variable return modes (such as Mudarabah and Musharakah).

These developments have led to the emergence of different models of Islamic Banking. Under this model, the relationship between savers and the bank is managed on the basis of Mudarabah. However, the bank also applies a number of other financial instruments permissible from a Shari'ah point of view (for example Murabahah, Musharakah, Ijarah, Salam and Al-Istisna).

The sources of funds can be divided into three main sources for Islamic Bank. The three sources of funds were identified as:

1. The bank's share capital
2. Mudarabah deposit
3. Demand deposits

The theoretical work and functions of banks outline are indeed highly useful and socially desirable. Islamic financial intermediation attempts to replace interest by other modes and instruments both for mobilizing savings and for putting those savings to productive use. People need banking services. Now, since the banking services are needed but interest is prohibited, Islamic economies have to find alternative ways of performing various banking instruments. This challenge provides the rationale of Islamic Banking.

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10 Munawar Iqbal, Philip Molyneux, No.7, p.27.
11 Ziauddin Ahmad, No.1, p.16.
12 Munawar Iqbal, Ausaf Ahmad, Tariqullah Khan, No.4, p.13.
2.2 Islamic and Conventional Banks

Islam has provisions for innovative products and practices by using the Ijtihad according to the holy Quran and Sunnah as the origin for all deeds. Islamic Bank works as Mudarib to invest savers' funds in general investment fund, specific investment fund or accept demand deposits on interest free basis. It can also perform the function of investment manager (Wakalah) and generate revenue as service charges. While in conventional banking investors are guaranteed a predetermined rate of interest and it aims to maximize the return even at the cost of society or other stakeholder. In conventional banking excessive use of credit and debt financing can lead to financial problems and promote materialistic attitude that leads to exploitation, which is fatal for society.\textsuperscript{13}

\textsuperscript{13}Ashfaq Ahmad, A comparative Study of Islamic banking in Pakistan: Proposing and Testing a Model (Islamabad: Iqra University, 2009), p.6.
Table 2.1: Differences between Conventional and Islamic Bank

<table>
<thead>
<tr>
<th>Main Difference</th>
<th>Islamic Bank</th>
<th>Conventional Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principles</td>
<td>Islamic banks follow the Principles of Sharia’h given by Allah Almighty to perform operations and activities.</td>
<td>Conventional banks follow manmade principles to perform operations and activities.</td>
</tr>
<tr>
<td>Source of Earnings</td>
<td>Profit, service charges and consultancy fee is the main source of earnings of Islamic banks. Profit is variable which may be negative in case of loss.</td>
<td>Interest is the main source of income for conventional banks that is charged on different types of loans/products. (Difference between interests charged from borrowers and paid to depositors). It assures a predetermined rate of interest.</td>
</tr>
<tr>
<td>Risk Sharing</td>
<td>Risk is shared among borrower, lender and bank.</td>
<td>Risk is fully transferred to others.</td>
</tr>
<tr>
<td>Profit Maximization</td>
<td>It aims at maximizing the profit but subject to principles of Sharia’h.</td>
<td>It aims at maximizing the profit without any restriction even at the cost of other stakeholders.</td>
</tr>
<tr>
<td>Objectives</td>
<td>Islamic bank works as a trading concern (Mudarib or Wakalah) to generate its income.</td>
<td>It generates income as financial intermediary. Its prime goal is the maximization of shareholders’ value at any cost.</td>
</tr>
<tr>
<td>Nature of Earnings</td>
<td>Income of Islamic banks varies depending upon business environment. It may be negative in case of loss.</td>
<td>Income of conventional bank is constant even if business suffers from loss because it charges fixed rate of interest irrespective of profit volume.</td>
</tr>
</tbody>
</table>

Source: Generated

2.2.1 Objectives of Islamic Banking:

Islamic Banks are to promote, and develop the banking services and products based on Islamic principles. Islamic Banks are also promoting establishment of investment companies or business enterprises so long as their activities are not restricted by Islam. The main guiding principle is the prohibition of interest and undertaking business and trade activities on the basis of fair and legitimate profit.\(^{14}\)

However, some of the most important objectives for the fundamental characteristics of the Islamic banking are:

1. Broad-based economic well-being with full employment and optimum rate of economic growth.
2. Socio-economic justice and equitable distribution of income and wealth.
3. Stability in the value of money to enable the medium of exchange to be a reliable unit of account, a just standard of deferred payment, and a stable store of value.
4. Mobilization and investment of savings for economic development in and equitable manner such that a just return is ensured to all parties concerned.
5. Effective rendering of all services normally from the banking system.¹⁵

Islamic Banks should neither be understood as solely profit-driven nor as a charitable organization. Instead, it is a vehicle in promoting and developing the Islamic community. Islamic Banks, although need to help the needy, must not forget their responsibilities towards the suppliers of funds to the entire community in accordance with Islamic covenant.

Islamic Banks are expected to make profits but are prohibited from making excessive profit at the expense of their customers (Interest). Islamic Bank’s objectives are mainly profit and morality.¹⁶ The objectives in Islam Banks are inviolable part of the ideology and the faith. They constitute an important input for considerable part of the juristic output. They carry sanctity to the extent by which they are based on the Quran and the Sunnah.¹⁷

2.2.2 Functions of Islamic Banking:

The Islamic Banks provide a number of functions. Some of these functions are normally provided by the commercial banks and some functions have been modified by

¹⁷Khiyar Abdalla Khiyar, No.9, p.163.
Islamic Banks because of the restrictions that they have to operate in accordance with Shari'ah. The functions of Islamic banks can broadly be listed as follows:

- Opening of accounts for individuals and companies and accepting cash deposits for safe custody and investment both in local and foreign currency.

- Giving credit and loans in conformity with Shari'ah.

- Purchase and sale of gold bullion.

- Purchase and sale of foreigner exchange on the spot rate only.

- Issue of letter credit.

- Issue of guarantee.

- Providing short term financing against collateral in the form of commercial papers at agreed commercial yield without interest.

- Collecting and processing drafts, cheques, promissory notes, bills of lading etc., on commission.

- Purchase and sale of shares, certificates of investment, financial papers and bonds without interest.

- Establishment and management of special funds for socially desirable purpose e.g. investment in trade, agriculture, industry or real estate.

- Providing finance on the basis of Mudarabah.

- Providing finance on the basis of Musharakah.

- Providing finance on the basis of decreasing participation.

- Operation of specified investment account.

- Direct investment by the bank.

- Leasing of machines, equipment, and tools.

- Sale and purchase of real estate.
- Carrying out agency function by appointing agents and working as agents.
- Sale and purchase for others on a pre-agreed profit bases (Murabahah).
- To establish solidarity and security of funds in order to cover deficits, in conformity with Islamic laws of cooperation.
- To provide technical, economic, financial, management and marketing consultancy service for the preparation of feasibility studies of project.

Islamic Banks perform a variety of fund-based and non-fund based functions to facilitate their customers. Some important functions are displayed in figure 2.1

**Figure 2.1: Function of Islamic Bank**

*Functions of Islamic Bank*

- **General Investment Fund**
- **Specific Investment Fund**
- **Accepts Deposits**
- **Agency & Gen. Utility Functions**
- **Islamic Bank**
- **Advance Loans** (Financing Products)
- **Primary Functions**
  - **Long Term**
    - Musharika,
    - Mudaribah and
    - Diminishing
    - Musharika etc.
  - **Medium Term**
    - Ijarah,
    - Ijarah-Wa-Iqtina
    - etc.
  - **Short Term**
    - Murabaha, Salam,
    - Muajjal, Istina
    - etc.

Source: Generated
It is not necessary that each Islamic Banks undertakes all of the above functions. They may arrange themselves to the functions most appropriate to them. It must suffice to say, that in general Islamic Banks perform all banking services and all commercial and financial investment on the basis of techniques permissible by Islamic Shari’ah.  

2.2.3 Strategies of Islamic Banks

Division of strategies is done in order to enhance firstly, the existence of Islamic Banks and then to improve its positions in the current markets within the current environment. These strategies are prerequisites of other strategies which are necessary to achieve the required result.

**Survival Strategies**

Adopting these strategies is important for Islamic Banks to stay as life-capable economic unit, to stay alive, at least in the current markets.

1. **Consolidation Strategy:**

This strategy is concerned with protecting and strengthening the current competitive position in the current markets of Islamic Banks, with the current product mix. This strategy is to focus on the core competences which are included in the Shari’ah commitment, the capital structure and the abundance of funds, which give the Islamic Banks a better competitive position against the traditional ones.

2. **Cost leadership Strategy:**

It must increase the competitive ability via achieving ratios of return for the stockholders and the depositors higher than the current ones. This releases the pressure on its

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management regarding risk-taking and investment decisions; hence, there will still be the managerial expenses which can be handled by an easier way than interest expense.

3. Merger and Acquisition Strategy:

According to the past experience of financial and non-financial institutions, this strategy considered to be one of the best strategies, because its positive effects on the consolidated firms regarding economics scale, competitive ability, and synergy.

Confrontation Strategies

1. Market Development Strategy:

Islamic Banks have a good opportunity to enter virgin markets, beside the availability of new sectors of customers as micro finance projects, women financing, private banking, investing in the privatized projects, and meeting the financial needs for governmental agencies. This will give Islamic banks a great advantage to win these sectors.

2. Diversification Strategy:

Islamic Banks can develop its current products in addition to innovate new financial products compliant to Islamic Shari'ah; this can go concurrently with introducing new non-traditional markets. This strategy includes shifting Islamic Banks toward developing new products and new markets in the same time.

Operational Strategies

1. Investment and Financing Strategies:

These strategies are related to money acquired from different resources and investing funds through proper allocation in order to achieve an acceptable profit.
2. Marketing Strategies:

Islamic banks may face the problem of increasing the complications of customers' need as a result of financial openness and availability of alternative choices for them in finance and investment. Such challenge requires reviewing the current marketing strategies of Islamic Banks by pricing it properly and distribution to targeted sectors of customers in a better way.

Human Resources Strategy

1. Development and Training:

This requires the Islamic Banks to meet its increasing need for employee with having the professional abilities as banks employee, besides a good knowledge of economic matters of Islamic Shari’ah. Efforts are needed to appoint qualified new employees taking into consideration such as their professional and religious knowledge. Islamic Banks can do so by establishing specialized departments or training centers.

2. Challenge Leadership:

As the targeted change for Islamic Banks to be a deep and structural, the leader of such changes must have unique characteristic like awareness, knowledge and enough flexibility to adopt the overall and operative strategies.

3. Informative Strategy:

The development in management sciences has led to great dependence on information, computerized activities and computerized information systems in particular. The abilities of Islamic Banks to adopt and implement the above mentioned strategies must stand basically on a solid information structure and high technology network.
Globalization Strategy

The main landmarks of this strategy include:

1. **Institutional Framework:**
   Many institutional organizations have been founded to administer the works of Islamic Banks, besides helping them in accounting aspects, liquidity management, and control etc. Such as AAOIFI, IIRA, IFSB, and GCIIBFI are examples of such organizations.

2. **Religious (Shari’ah) Framework:**
   It is related to converging religious viewpoints regarding a lot of new problems related to investment, financing instruments, and modes that currently face Islamic Banks. International religious standards can be prepared by Assembly of Islamic Jurisprudence to be followed by local Islamic banks.

3. **Human Resources:**
   All professionals and scholars agree that Islamic Banks are in need for employees who have the required qualifications as bank professionals besides the Islamic background and religious commitment.

4. **Promotion Framework:**
   Since all Islamic Banks are subject to a hostile propaganda that distrusting goals and activities through linking it with “terrorism”. Islamic banks are working in a conflicting media campaigns via conferences, seminars, press release, and other way to correct this view about Islamic Banks’ goals and activities.

5. **Research and Studies:**
   Scientific research and strong approaches that Islamic Banks can rely on to develop its abilities in facing financial globalization is essential. The need for
creating new financial instruments and modes, and developing the current ones; besides, assistance employees' skills and knowledge can be met by scientific research.19

2.2.4 Types of Islamic Bank

Islamic banks may be defined as banking institutions which are based on Islamic ideology in the procedure of banking activity. This is general definition and may include all kinds of Islamic Banking institutions. From the view point of purpose of the banks, Islamic Banks may be classified into the following groups:

1. Development Banks

The main purpose of development banks is to support the process of social and economic development amongst its members. Usually its clientele includes various governments. For example such an Islamic Bank is the Islamic Development Bank (IDB)

2. Special-Purpose Islamic Banks

Some Islamic Banks may be established to fulfill some specific purpose or serve some special class of clientele; such banks may be termed Special-Purpose Islamic Banks and may further be classified as Social Banks, Agricultural Banks, and Industrial Banks etc. For example, Nasser Social Bank of Egypt is a public authority with an autonomous status which was established in 1971. The Bank processes certain traditional banking functions such as acceptance of deposits and promotion of saving habits but its main objectives are social, such as introduction of pension and insurance to certain class of people, the granting of financial assistance to persons

19Ahamed Al-Ajouni, Developing Strategies for Islamic Banks to Face the Future Challenges of Financial Globalization (Jordan: Amman Arab University), pp.4-9.
facing hardships, the granting of interest-free loans to small industrial projects, lending to University higher institute student etc.

Ownership of the Islamic Banks

On the basis of ownership, Islamic Banks may be divided into international Islamic Banks, Government-owned Islamic Banks, Privately-Owned Islamic Banks, and Cooperative Islamic Banks. Among the existing Islamic banks, the Islamic Development Bank is an International bank. The Nasser Social banks is a wholly government owned banks.20

2.2.5 Business Practice of Islamic Banking

Contemporary Islamic Banks have been founded with regard to their main layout, their basic functions of mobilizing financial resources and using them to finance those who are in need for available funds. Obviously, the modes of financing that are, in the case of Islamic Banks, derived from the Islamic system and structured within the Islamic legal framework.

Modes of Finance

Fund Mobilization:

Resources are mobilized from shareholders and savings owners. In other words, savings are mobilized on the basis of sharing rather than interest-based lending. Hence, the Islamic Banks has usually two broad categories of deposit:

(1) Investment Deposits: That share in the return of investment operation in proportion to the amount of deposit and on the basis of distributing the net return on a contracted ratio.

20Ausaf Ahmad, No.18, pp.13-14.
(2) Demand Deposit: Which are guaranteed and represent liabilities, and they do not earn any return.

Fund Utilization:

Islamic banks use available funds in three major categories of financing modes: sharing mode, sale mode and leasing mode.21

1. Sharing Mode

Islamic Banks finance to projects with the expectation of share in return. Obviously, if a project runs into losses, all capital providers and finance contributors loose proportionately. There are two forms of applications of this principle: full equity sharing and non-voting equity financing. In full equity sharing, the bank would be represented on the board of executive directors and would share in formulating policies and managerial decision, while in no-voting financing Islamic Banks fully entrust managerial decision-making to the user of funds.22

2. Sale Mode

The bank would be asked to buy goods and give them to users (producer or consumers) against future repayment. Sale modes may take many forms. Two other forms are also practiced by Islamic banks: construction/manufacturing contract and deferred delivery contract. Construction/manufacturing contract is generally used to finance land development, infrastructure, manufacturing, and industrial construction; while deferred delivery is usually an agricultural financing contract that provides farmers with funds required for their operations against delivery other output at the season.23

22Monzer Kahf, No. 2, p.6
3. Leasing Modes

As practiced in leasing companies and recently in many traditional banks, leasing modes can have several forms with fixed or variable rents, declining or fixed ownership, along with different conditions regarding the status of leased assets at the end of the lease period.²⁴

Figure 2.2: The Islamic Banking Model

![Diagram of Islamic Banking Model]

Sources: The IBF Model: basic Policy instruments

²⁴Monzer Kahf, No.2, p.6
It is well known that Islamic banks utilize Islamic modes of financing on the Asset and Liability sides of the balance sheet. The following tables attempt to explain this aspect.

Table 2.2: Theoretical Balance Sheet of an Islamic Bank Based on Maturity Profile

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term trade finance (cash, Murabahah, Salam)</td>
<td>Demand deposits (Amanah)</td>
</tr>
<tr>
<td>Medium-term investments (Ijarah, Istisna)</td>
<td>Investments (Ijarah, Istisna)</td>
</tr>
<tr>
<td>Long-term partnerships (Musharakah)</td>
<td>Special Investment Accounts (Murabahah Musharakah)</td>
</tr>
<tr>
<td>Fee-based service (Joalah, Kifalah, and so forth)</td>
<td>Reserves</td>
</tr>
<tr>
<td>Non-banking asset (Property)</td>
<td>Equity capital</td>
</tr>
</tbody>
</table>

Table 2.3: Theoretical Balance Sheet of an Islamic Bank Based on Functionality Profile

<table>
<thead>
<tr>
<th>Asset</th>
<th>Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash balance</td>
<td>Demand deposits (Amanah)</td>
</tr>
<tr>
<td>Financing assets (Murabahah, Salam, Ijarah, Istisna)</td>
<td>Investment accounts (Mudarabah)</td>
</tr>
<tr>
<td>Investment assets (Mudarabah, Musharakah)</td>
<td>Special Investment Accounts (Mudarabah, Musharakah)</td>
</tr>
<tr>
<td>Fee-based service (Joalah, Kifalah, and so forth)</td>
<td>Reserves</td>
</tr>
<tr>
<td>Non-banking asset (Property)</td>
<td>Equity capital</td>
</tr>
</tbody>
</table>

The above tables present a stylized balance sheet of an Islamic bank, displaying different activities and financial instruments. It can be considered as a good starting point for understanding the dynamic of the risks inherent in Islamic banks.24

2.2.6 Sources and Uses of Funds

The difference between Islamic Banks and interest-based banks rely on how they raise funds and utilize them for better performance.

I) Sources of Funds Created by Islamic Banks

1. **Shareholder's equity of Islamic Banks** is almost similar in nature to the shareholder's equity of conventional banks. However, the equity in Islamic banks may be larger due to the fact that the Islamic Banks is a multi-purpose bank directing a special portion of its resources toward medium and long term uses.26

2. **External sources** comprises mainly of:
   - A). Current accounts
   - B). Savings account
   - C). Investment accounts

(A). Current Accounts

All Islamic banks create current accounts on behalf of their client: individuals and business firms. These accounts are arranged for the safe custody of deposits and for the convenience of customers. However, the main characteristic of these accounts, as created by Islamic Banks, are listed below:

1. Current accounts are generally known as call deposits or demand deposits. These accounts can be opened either by individuals or companies.
2. The bank guarantees the full return of these deposits on demand and the depositors is not paid any share of the profit or any other return in any form.
3. Depositors authorize the bank to utilize their funds at the bank's own risk. However, if there is any profit resulting from the employment of these funds, it accrues to the banks and if there is any loss, it is also borne by the bank.
4. With these accounts, there are no condition with regard to deposits and withdrawals.
5. Usually account holders have a right to draw checks on their accounts.27

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(B). Saving Accounts

Islamic Banks also accept savings deposits from individuals. They operate savings accounts by four different methods as follows:

1. Accepting savings deposits on the principle of Al Wadiah (trust), requesting the depositors to authorize the bank to use the funds at its own risk, but guaranteeing full return of the deposits and sharing any profits voluntarily.

2. Accept savings deposits with an authorization to invest them and sharing profits in an agreed contract for the period in which a required minimum balance is maintained.

3. Treating savings deposits as Qardh-e-Hasan from depositors to the bank and granting pecuniary or non-pecuniary benefits to depositors.

4. Accepting savings deposits as part of an investment pool and treating them as investment deposits.²⁸

(C). Investment Accounts

Investment deposits are Islamic Banks counterparts of term deposits or time deposits in the conventional system. They are also named Profit and Loss Sharing (PLS) Account or Participatory Accounts. The main characteristics of investment deposits can be explained as follow:

1. Investment accounts can be opened by individuals or companies.

2. Generally these accounts are opened for a specific period, e.g. three months, six months, one year or more.

3. The return on investment is stipulated according to actual profits from the investment operations of the banks and shared in an agreed proportion by depositors according to the amount of their deposits and the period they are held by bank.

²⁸Khiyar Abdalla Khiyar, No.9, pp.169-170.
4. Generally knowing, depositors do not have the right to withdraw from these accounts as it is customary in time deposits in convention banks. However, withdrawals may be made under special circumstances with the depositor forfeiting his share of the profit for the withdrawn amount.

5. Usually, banks insist on a specified minimum amount to open and maintain the investment account.

6. Most banks issue an investment certificate to depositors stating the terms and conditions of the deposit.  

**Joint/General Investment Accounts**

Some Islamic Banks establish an investment pool instead of fixed-term deposits. The investment pool takes the form of general investment account in which investment deposits of different maturities are pooled together. They are not stipulated to any specific investment project but are utilized in different financing operations of the banks. The profits are calculated and distributed at the end of the accounting period which is three months, six months or one year on a pro rata basis.  

**Limited Period Investment Deposits**

Some Islamic Banks also accept investment deposits under this scheme which are accepted for a specified period and mutually determined by the depositor and the bank. The contract terminates at the end of the specified period, but profits are calculated and distributed at the end of financial year.  

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29 Ausaf Ahmad, No.28, pp.27-28.
30 Khiyar Abdalla Khiyar, No.9, pp.170-171.
31 Ausaf Ahmad, No.28, p.29.
Unlimited Period Investment Deposits

These investment deposits differ from limited period deposits without specifying the period. Deposits are automatically renewable unless a notice of three months is given to terminate the contract. No withdrawals of further deposits are permitted in this kind of contract, but customers are allowed to open more than one account. The profits are calculated and distributed at the end of the financial year.\(^{32}\)

II) Use of Funds by Islamic Banks

Islamic banks differ with commercial banks usually with their uses of funds. They provide finance on the basis of financial transaction permitted by the Shari'ah. These financial practices are explained below.

- Mudarabah (Profit Sharing)

Mudarabah is a business contract between two parties which own dissimilar resources. One party provides the capital and the other skill of trade. The first tier of Mudarabah agreement is between the bank and the depositors who agree to put their money in the bank’s investment account and to share profit with it. The second tier of Mudarabah agreement is between the bank and the entrepreneurs who seek finance for their projects. The Mudarabah agreement is based on justice as it grants an equal position to both parties of agreement. Firstly, both parties have an equal position in the determination of ratio in which profits shall be shared between them. Secondly, in case of loss, the provider of capital suffers a reduction of his principal amount; the provider of labour is deprived of any reward of his labour, time and effort. Thirdly, both parties are treated equally if there is any violation of the agreement.\(^{33}\)

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\(^{32}\) Ausaf Ahmad, No. 18, p. 18.

\(^{33}\) Ausaf Ahmad, No. 18, p. 19.
- **Musharakah (Partnership)**

Musharakah literally means sharing. In the Islamic finance literature it refers to a joint enterprise in which all the partners share the profit or loss of the joint venture. Musharakah as a financial contract refers to an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as general rule. The profit of the enterprise is shared among the partners in agreed proportions while the loss is shared strictly according to capital contributions.\(^{34}\)

- **Murabahah (Mark-Up or Cost-Plus-Based Financing)**

The client approaches the Islamic Banks to finance the purchase of a specified commodity. The bank, either itself or through an agent (who could be the client himself) collects all the required information of the commodity, its price, names of dealers, etc. The bank informs the client of these detail as well as of the margin which it would like to charge on the original price. If these conditions are acceptable to client, a Murabahah contract will be signed between the bank and the client. The bank will purchase the specified commodity from a seller of its choice, paying the price of the commodity in cash. Once the ownership of the commodity is transferred to the bank, it sells the commodity to the client on a deferred payment basis against an agreed price.\(^{35}\)

- **Salam (Forward Sale)**

According to Islamic jurisprudence the essential conditions of a valid sale include that the commodity should be ready at the time of the sale. However, Salam and Istisna are the exceptions which are permitted according to Islamic law. Hence, Salam is a contract of forward sale, whereby a commodity is sold on a future date for which the complete price is

\(^{34}\) Munawar Iqbal, Philip Molyneux, No.7, p.20.

\(^{35}\) Khiyar Abdalla Khiyar, No.9, p.173.
paid on the spot. Salam was originally allowed to meet the needs of small farmers who needed money during the harvesting period to meet expenses. Since borrowing on interest was not permitted, they were allowed to use forward sale.  

- **Istisna (Progressive Financing)**

It is also called *purchase by order*. Istisna is the second method of sale where the commodities can be sold before they are ready. Istisna is applied for goods made to order. It allows for on-the-spot payment and deferred delivery or a deferred payment and a deferred delivery. Any party can cancel the contract before manufacturing work starts. However, after the manufacturing work has started, the contract cannot be cancelled. However, there are some differences between the two which are summarized below:

I. The subject of Istisna is always a thing which needs manufacturing, while Salam can also be affected on things that do not involve manufacturing.

II. In the case of Salam full payment of price is necessary, whereas in the case of Istisna the payment can be delayed.

III. The time of delivery in case of Salam must be specified at the time of the contract. In the case of Istisna this is not necessary.  

- **Ijarah (Leasing)**

In this system, the Islamic Banks acquire certain assets such as machines, buildings, or equipment and allow the customers to use them for a certain period against an agreed price. This is leasing of assets. The terms of lease are decided by mutual agreement.  

- **Qardh al Hasan (Interest-free loans)**

Most Islamic banks also provide interest-free loans to their customers. However, practices differ in this respect. The purpose of these interest-free loans is to help them to

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38 Ausaf Ahmad, No.18, p.21.
become independent or to raise their income and standard of living. Islamic Bank should take care to see that these loans are granted to those who are in need of support and assistance them to rehabilitate economically.39

Table 2.4: Comparative Features of Islamic Financing Techniques

<table>
<thead>
<tr>
<th>Features</th>
<th>Muddarabah</th>
<th>Musharakah</th>
<th>Ijara Leasing</th>
<th>Jual Salam</th>
<th>Murabahah</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of Financing</td>
<td>Investment Based</td>
<td>Investment Based</td>
<td>Leasing Based</td>
<td>Combination of cash and trading</td>
<td>Combination of debt and trading</td>
</tr>
<tr>
<td>Rate of the capital provided to the management of funds</td>
<td>Nil</td>
<td>Full control</td>
<td>Full control on the sale of the balance</td>
<td>Nil</td>
<td>Full control on the sale of the balance</td>
</tr>
<tr>
<td>Risk bearing by the capital provider</td>
<td>2. To the full extent of the capital as well as the opportunity cost of capital. 3. Until the goods are disposed of. 4. Even after the expiry of the contract until the goods are finally disposed of. 5. Only for a short period and the goods are purchased and taken over by the financier.</td>
<td>Same as Muddarabah</td>
<td>1. To the full extent of the capital as well as the opportunity cost of capital. 2. Until the goods are disposed of. 3. At the expiry of the contract until the goods are finally disposed of. 4. Only for a short period.</td>
<td>1. To the full extent of the capital as well as the opportunity cost of capital. 2. Until the goods are disposed of. 3. At the expiry of the contract until the goods are finally disposed of. 4. Only for a short period.</td>
<td>1. To the full extent of the capital as well as the opportunity cost of capital. 2. Until the goods are disposed of. 3. At the expiry of the contract until the goods are finally disposed of. 4. Only for a short period.</td>
</tr>
<tr>
<td>Uncertainty of rate of return</td>
<td>Complete uncertainty</td>
<td>Complete uncertainty</td>
<td>Complete uncertainty</td>
<td>Complete uncertainty</td>
<td>Uncertainty only for a short period of the contract</td>
</tr>
<tr>
<td>Cost of Capital</td>
<td>Variable</td>
<td>Variable</td>
<td>Fixed and predetermined</td>
<td>Uncertain</td>
<td>Fixed and predetermined</td>
</tr>
<tr>
<td>Relationship of the cost of capital and the rate of return on capital</td>
<td>Perfect correlation</td>
<td>Perfect correlation</td>
<td>Uncertain</td>
<td>No correlation</td>
<td>Strong correlation but not perfect</td>
</tr>
</tbody>
</table>

2.3 Islamic Financial System: A Blueprint

Islamic scholars have not only established the basic principles and norms, but also identified the contractual mechanisms that conform to these norms and do not violate them in any manner. Below, is provided an overview of the various financial products and the underlying contractual mechanisms. These contracts are called Shari'ah40

39Khiyar Abdalla Khlyar, No.9, p178.
40Mohammed Obaidullah, Islamic Financial Service, part II, A Financial System Based on Ethics (Jeddah: King Abdulaziz University), p.15.
### Table 2.5: Islamic Financial System: A Blueprint

<table>
<thead>
<tr>
<th>Products/Services</th>
<th>Underlying Contract(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Deposit Services</td>
<td></td>
</tr>
<tr>
<td>Current Deposit</td>
<td>Wadiah Wad Dhamana / QardHasan</td>
</tr>
<tr>
<td>Savings Deposit</td>
<td>Wadiah Wad Dhamana / Mudaraba</td>
</tr>
<tr>
<td>General Investment deposit</td>
<td>Mudaraba</td>
</tr>
<tr>
<td>Special Investment deposit</td>
<td>Mudaraba</td>
</tr>
<tr>
<td>• Retail / Consumer Banking</td>
<td></td>
</tr>
<tr>
<td>Housing &amp; Property Finance</td>
<td>BBA / Ijarawakalitina /Diminishing Musharaka</td>
</tr>
<tr>
<td>Hire Purchase (Ijara Thumma Al-Bai)</td>
<td></td>
</tr>
<tr>
<td>Share Financing</td>
<td>BBA / Mudaraba / Musharaka</td>
</tr>
<tr>
<td>Working Capital Financing (Murabahah)</td>
<td>BAI Al-Einah / Tawarrug</td>
</tr>
<tr>
<td>Credit Card (Bai Al-Einah Tawarrug)</td>
<td></td>
</tr>
<tr>
<td>Charge Card (QardHasan)</td>
<td></td>
</tr>
<tr>
<td>• Corporate Banking/ Trade Finance</td>
<td></td>
</tr>
<tr>
<td>Project Financing</td>
<td>Mudaraba / Musharaka / BBA / Istisna / Ijara</td>
</tr>
<tr>
<td>Letter of Credit</td>
<td>Musharaka / Wakala / Murabahah</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>Diminishing Mudaraba / Musharaka</td>
</tr>
<tr>
<td>Financing Syndication</td>
<td>Musharaka + Murabahah / Istisna / Ijara</td>
</tr>
<tr>
<td>Revolving Financing</td>
<td>BAI Al-Einah</td>
</tr>
<tr>
<td>Short-term Cash Advance</td>
<td>BAI Al-Einah Tawarrug</td>
</tr>
<tr>
<td>Working Capital Finance</td>
<td>Murabahah / Salam Istijar</td>
</tr>
<tr>
<td>Letter of Credit</td>
<td>Murabahah</td>
</tr>
<tr>
<td>Letter of Guarantee</td>
<td>Kafala + Ujr</td>
</tr>
<tr>
<td>Leasing</td>
<td>Ijara</td>
</tr>
<tr>
<td>Export/ Import Finance</td>
<td>Musharaka / Salam / Murabahah</td>
</tr>
<tr>
<td>Work-in-Progress, Construction Finance</td>
<td>Istisna</td>
</tr>
<tr>
<td>Bill Discounting</td>
<td>BAI Al-Dayn</td>
</tr>
<tr>
<td>Underwriting, Advisory Services</td>
<td>Ujr</td>
</tr>
<tr>
<td>• Treasury / Money Market Investment</td>
<td></td>
</tr>
<tr>
<td>Products</td>
<td></td>
</tr>
<tr>
<td>Sell &amp; buy-back agreements</td>
<td>BAI al-Einah</td>
</tr>
<tr>
<td>Islamic Bonds</td>
<td>Mudaraba / Musharaka + BBA / Istisna / Ijara</td>
</tr>
<tr>
<td>Government Investment Issues</td>
<td>QardHasan / Salam / Mudaraba</td>
</tr>
<tr>
<td>• Other Products &amp; Services</td>
<td></td>
</tr>
<tr>
<td>Stock-Broking Services</td>
<td>Murabahah / Wakala Joala</td>
</tr>
<tr>
<td>Funds Transfer (Domestic &amp; Foreign)</td>
<td>Wakala / Joala</td>
</tr>
<tr>
<td>Safe-Keeping &amp; Collection (Negotiable</td>
<td>Wakala / Joala</td>
</tr>
<tr>
<td>Instruments)</td>
<td></td>
</tr>
<tr>
<td>Factoring</td>
<td>Wakala / Joala BAI al-Dayn</td>
</tr>
<tr>
<td>Administration of Property, Estates and</td>
<td>Wakala / Joala BAI al-Dayn</td>
</tr>
<tr>
<td>Wills</td>
<td>Wakala / Joala</td>
</tr>
<tr>
<td>Hiring of Strong Boxes Amana</td>
<td>Wakala / Joala</td>
</tr>
<tr>
<td>Demand Draft, Traveller’s Cheques</td>
<td>Ujr / Joala</td>
</tr>
<tr>
<td>ATM Service, Standing Instruction,</td>
<td>Ujr</td>
</tr>
<tr>
<td>Telebanking</td>
<td></td>
</tr>
</tbody>
</table>

*Source: Range of Islamic Banking Products and Services*
2.3.1 Financial Structures

In developing any banking system, its term structure of finance is very significant. By term structure it refers to the duration of distribution to provide finance. Obviously, financial needs of business are different and they vary from unit to unit and also from time to time. Conceptually speaking, the term structure of finance may be classified into following groups:

I. Very short term finance, the duration of which may not exceed from a few days to a few weeks.

II. Short term finance which is usually of duration less than 90 days.

III. Medium term finance which may have varying duration i.e. 3 months, 6 months, one year.

IV. Long term finance whose duration may go from 2 years to 10 years or more.  

Table 2.6 Financial Structures

<table>
<thead>
<tr>
<th>Source of Funding (Liabilities and Equity)</th>
<th>Application of Funding (Asset)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity capital and shareholders’ reserve</td>
<td>Short-term trade finance (Mudarabah, Salam)</td>
</tr>
<tr>
<td>Current and Saving deposit (Amanah)</td>
<td>Regulatory cash reserve requirement</td>
</tr>
<tr>
<td>Investment account (Mudarabah)</td>
<td>Medium-term investment (Ijarah, Istisna)</td>
</tr>
<tr>
<td>Special investment account (Mudarabah, Musharakah)</td>
<td>Long-term partnerships (Musharakah)</td>
</tr>
<tr>
<td></td>
<td>Fee-based services</td>
</tr>
</tbody>
</table>

2.3.2 Organizational Structures

There are several organizational structures of Islamic Banks which depends on specific regions or countries. A considerable deal of attention was paid to the idea of establishing Islamic Banks both in public and private sectors. As a result, the Nasser Social

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41 Ausaf Ahmad, No. 18, pp. 48-49.
Bank was established in Egypt as a Government owned bank to handle social activities. According to its statute, the bank was permitted to practice banking activities without interest.

The distinct event was followed by the establishment of a number of Islamic Banks in various Islamic countries in private sector, although some local governments and semi-governmental bodies became the shareholders of some Islamic Banks such as Faisal Islamic Bank of Egypt, Dubai Islamic Bank, Kuwait finance house and Islamic Bank of Thailand.

The Islamic banking structures comprise of:

- Local comprehensive Islamic Banking System
- An International Islamic Bank owned by Governments.
- Private Islamic Banks with equity participation by government bodies
- Private Islamic Banks
- Islamic Banking branches of Conventional Banks.\(^4^2\)

Generally the existing Islamic Banks are joint stock companies. The organizational structure of Islamic Banks is not much different from the general structure of such companies. The company is floated either by a few individual or governmental agencies. The shares are bought by private individuals. Sometimes, certain restrictions may be imposed on subscription of shares according to the law of the land. For instance, only Kuwait nationals are allowed to buy the shares of Kuwait Finance House. The shareholders elect a shareholders’ committee and a board of directors headed by a managing director or chairman who are responsible for the day to day functioning of the company, the auditor’s report and audited statement accounts are reported annually to annual meetings of shareholders.

As far as financial structure is concerned, Islamic Banks may be classified into two broad groups:

\(^4^2\) M.A. Mannan, Monzer kahf, Ausaf Ahmad, No.27, p.147.
(i) Islamic banks belonging to some financial holding company.

(ii) Other Islamic Banks established by private or semi-governmental initiative. 43

2.3.3 Stabilities

The stability of a banking system can be explained on the basis of its ability to absorb unanticipated shocks. A stable banking system absorbs these shocks without disrupting its smooth system. A remarkable characteristic of conventional banks is that they offer par redemption of deposits (principal is guaranteed) on demand. Therefore, banks also hold risky assets such as loans. As a result, banks are vulnerable to 'runs' (large-scale withdrawal) on deposits. If depositors have negative information about the value of bank loan or negative news about the quality of the loan portfolio, than they will have enticement for withdrawal of deposits.

An Islamic Banking system, under an Islamic profit-and-loss-sharing (PLS), has a unique equality between liabilities and assets of the banks. In fact the two sides are transparent. The assets are no more risky than what is allowed by the kind of liabilities which the banks have issued. However, in the case of a major shock, there is no incentive on the part of depositors to withdraw their deposits from the banks. This is because each depositor is holding a share in the bank’s portfolio, thus his share is always available, no matter what other depositors do. In fact, under this management, there will be a tendency to remain a depositor in the bank in the expectancy of a future revaluation of bank assets rather than accepting a loss in the nominal value of deposits. 44

The argument proceeds in the literature on Islamic Banking are that a switch over from interest based banking to PLS based banking would appear highly stable to the banking system. In the interest based system, the nominal value of deposit liabilities is fixed. However, there is no assurance on the assets side that all the loans and advances will be

43 Ausaf Ahmad, No.18, p.14.
44 Khiyar Abdalla Khiyar, No.9, pp.181-182.
recovered. Shocks on the assets side, therefore, lead to divergence between assets and liabilities, and the banking system can suffer a loss of confidence in the process, leading to banking crises. In the PLS based system, the nominal value of investment deposits is not guaranteed and shocks to the assets positions are promptly absorbed in values of investment deposits, this minimizes the risk of bank failures and increases the stability of the banking system.\textsuperscript{45}

A conventional bank has liabilities that include demand, time and saving deposits, which the bank guarantees on one hand and on the other hand, it has assets that are mostly composed of debt instruments each of which has a quality that depends on the liability side. A bank operating according to Islamic rules of finance has liabilities of different nature. Only demand deposits are guaranteed. Meanwhile, investment deposits are performed on profit-and-loss-sharing basis. When such bank faces specific macroeconomic or specific crises, investment deposits automatically share the risk the bank is less likely to fall and a bank “run” is less probable, it can therefore be said that Islamic banking system is relatively more stable when compared to conventional bank.\textsuperscript{46}

It has been clearly shown that the Islamic Banking system is more stable than the inherently unstable conventional banking system which affected into many bank runs and panics.\textsuperscript{47} Speculative activities related to interest rate expectations would become out of place. Changes in spending would automatically be reflected on changes in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces. It is, therefore, interesting to know that Islamic finance supports market forces and mechanism more than does conventional finance.\textsuperscript{48}

\textsuperscript{45}Ziauddin Ahmad, No.1, p.30.
\textsuperscript{47}Khiyar Abdalla Khiyar, No.9, p.183.
\textsuperscript{48}Mabid Ali Al Jarhi, No.47, p.10.
2.3.4 Efficiencies

For financial institutions, efficiency would mean improvement profitability, greater amounts of funds intermediated, better prices and service quality for consumers, and greater safety and soundness if some of the efficiency savings are applied towards improving capital buffers that absorb risk.\(^{39}\)

Conventional finance allocates financial resources with significant regard for borrower’s ability to repay loan principal and interest. In mode of Islamic finances that are based on equity and profit sharing, focus would be on the profitability and rate of return of the concerned investment. This would enhance the efficiency of the financing process and reinforce efficiency in the real sectors.\(^{59}\)

In general, the efficiency of Islamic Banks is important for three reasons.

Firstly, an improvement in cost efficiency means achieving greater profit and increasing the chance of survival in competitive markets.

Secondly, customers are interested in knowing the prices and the quality of bank services as well as new services that banks could offer, and these are strongly dominated by a bank’s overall efficiency of operation.

Thirdly, an awareness of efficiency features is important to help markets to stipulate policy that affect the banking industry as a whole.\(^{51}\)

For conventional banks, interest-based loans aim to those who are the most credit worthy. They finance projects expected to be most productive (profitable). Whether the actual profits are high or low, the bank gets the predetermined rate. This changes the bank’s

\(^{39}\)Munawar Iqbal, Philip Molyneux, No.7, p.88.
\(^{50}\)Mabid Ali Al Jarhi, No.47, p.9.
\(^{51}\)Munawar Iqbal, Philip Molyneux, No.7, p.89.
focus from the quality of the project being financed by its loan to the ability of the borrower. Creditworthiness and not the expected profitability of the project are the criteria to allocate funds for investment in the present system. This is inefficient. The bank’s contract with business be based on profit sharing, it will be the expected profitability of projects that will rule.\textsuperscript{52}

It has been expressed that a financial system based on an Islamic framework of profit sharing would be more efficient in allocating resources as compared to the conventional interest based system.\textsuperscript{53} A profit sharing based system of banking would be more efficient, more stable and more just than the one it has now. As a matter of fact, interest based financial intermediation is the major cause of instability in the system as it works at present. Also it puts entrepreneurship and organizational ability at a disadvantage, granting a privilege to owners of money which is totally unjustified.\textsuperscript{54}

2.3.5 Main Problems

Being a rather new type of banking institution, the existing Islamic banks are facing a number of problems. Some of these problems are bank-specific as any new institution faces in the initial year of its establishment. The art of Islamic banking shall be perfected only through trial and error as the art of interest-based banking was evolved through experience. Each of these problems can be briefly explained as follows.

1. Expansion and Regional Diversification

In view point of the size and diversity of the Islamic world, these banking institutions can make a beginning but possibly cannot achieve any perceptible change. Compared to their interest-based banks, Islamic Banks are operating at a relatively small scale. Hence

\textsuperscript{52}Khiyar Abdalla Khiyar, No.9, p.185.  
\textsuperscript{53}Ziauddin Ahmad, No.1, p.27.  
\textsuperscript{54}Khiyar Abdalla Khiyar, No.9, p.184.
expansion and development of Islamic Banks are necessary if they have to serve as vehicles of social and economic change along the Islamic lines particularly in Muslim countries.

2. **Diversification of Investment**

At present the Islamic Banks have a narrow operation. Their portfolio structure is not well diversified, in the beginning of experiment with Islamic Banking; it was vital for the banks to choose less risky and quick return type of investment projects for a variety of reasons. It would bring back the principal amount, generate profits and give access to resources for further expansion.\(^5\)

3. **Profitable Placement of Surplus Liquid Funds**

A problem which some of the Islamic Banks are facing particularly those is profitable management of surplus liquid funds. It is believed in the Islamic banking circles that problem of excess liquidity is rather serious. This problem is in fact the result of the situation that arises due to construction boom in which some of the Islamic banks participated through Murabahah operations and realized quick profit is over and there are no more avenues for productive investment in the economy.\(^6\)

4. **Exchange of deposits**

The problem of exchange of deposits has appeared which need to be solved in accordance of Shari’ah. The problem may be explained as follows: The Islamic bank A may have a surplus of U.S. Dollars and be in need of Pound Sterling. While Islamic bank B in a different country may have a surplus of Pounds Sterling but might be in need of

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\(^5\) Ausaf Ahmad, No. 18, pp. 63-64.

U.S Dollars. The way of solution to this problem is that agreement should be reached on the kind of two currencies for which exchange of deposit is to be made among the Islamic Banks and value of each deposit is to be calculated at the prevailing exchange rate.\(^5\)

5. Deposit Mobilization in Poor Countries

Islamic Banks in poor countries will have to make a special effort for resources mobilization. Hence, it shall be important for them to undertake regional diversification so that Islamic banking does not remain concentrated only in urban centers. Large masses of population are concentrated in the rural areas in poor Muslim countries. In the event of regional diversification of Islamic banking, it might become possible to utilize the hidden and potential savings in the rural sector of these economies.

6. Penalty Clause for Delay in Payment

One problem which an Islamic Banks faces is how to deal with cases of delay in payment. In the interest-based banks, it is easier to solve this problem as interest gets accumulating and some time the rate increased if the debt is not paid promptly. Since Islamic banks do not charge interest, delay in due payment may cause a number of problems for them. One way to solve this problem is to sell the collateral against which finance is provided by the Islamic Banks. However it may not solve the problem completely. Hence, it is suggested that Islamic banks may stipulate some penalty on defaulters for delay in payment in accordance with the stipulations of agreement in any one of the following ways:

1. Claiming part of the profit which customer might have made during the period of default.

II. Claiming the profit which the banks could have made if the held up funds were returned promptly i.e. opportunity cost of these funds.

Some Other Problems

In some countries, Islamic Banks have to keep a certain portion of their deposits with the central banks. If this ratio is very high, (25 percent as it really the case with some Islamic Banks) it may have adverse effects for the expansion and development of Islamic Banks. If there are more than one Islamic Banks in each country, then probably, it would be possible to convince the central banks to adopt different policies towards Islamic banks.

Firstly, central banks must be persuaded that they accept a lower proportion of total deposits in case of Islamic Banks.

Secondly, the Islamic banks must be allowed to borrow from the central banks against their deposit on an interest free basis.

Another problem which most of the Islamic Banks face is the lack of technical capacity to identify and examine the profitable projects. A sound and competent project evaluation department is a must for Islamic banks. Joint efforts of Islamic banks are required in this area to remove bottlenecks of technical and personal knowhow.\footnote{Ausaf Ahmad, No.18, pp.67-68.}

2.3.6 Achievement Factors

The Islamic banking system is proved to be ideal for all Muslim believers. It is claimed that the funds of those who might not want to support the interest banking system are brought to Islamic Banks. Once the system has been founded most of these funds are believed to have moved to Islamic Banks. This faith factor was one of the several reasons in
the beginning in the mind of Muslims believers. However there are many other factors which have contributed in the success of Islamic Banks are as following.\textsuperscript{59}

**Banking Efficiency**

Banking efficiency is the extent to which a bank's management is able to enhance its assets and maximize its profits in both the long-run and the short run. There is no doubt that the Islamic Banks is fundamentally different from the conventional banks in the nature of its relationship with its depositor i.e. a relation of partnership. This different nature of bank / depositor relations express that the management policy of an Islamic Banks should be fundamentally characterized by the maximization of both shareholders profit and depositor's profit. Therefore, banking efficiency is the most important of success factor.

**High Level of Trust**

It is evident that trust is the first foundation for the success of any bank. In addition, the reputation of Shari'ah board also important. It is very important for every Islamic bank to devise an effective institutional framework of Shari'ah supervision which enables the banks to combine effectiveness with reputation, such that it would be able to get real trust that it can use in marketing its services and new innovative financial products.

Another important aspect in gaining the confidence of clients is the bank's capital strength that persuades trust in the bank's future and its commitment. This gives the depositors a sense of security on their investment and current deposits and a peace of mind based on investment of bank's own capital in various project.

\textsuperscript{59} B.A. Bashir, *Successful Development of Islamic Banks* (Sudan: Department of business administration, University of Khartount, 1984), p.62.
Efficiency of Investment, Financial Engineering and Marketing Departments

The three departments should be well equipped, trained and prepared. The investment department generates revenues for both shareholders and depositors and it is the one that directly influences the bank's profitability. Another success factor of the Islamic bank is based in its financial engineering department. This department must always be able to provide a continuous flow of new instrument, window and investment contracts that help the bank to attract new customers and offer new service. The marketing department has a key role in the bank's ability to attract both deposits and investments. It is the department that is directly responsible for the promotion and growth of the bank's business.

Preservation of Banks and Customer's Assets

This is the responsibility of the department of liquidity and investment under direct supervision of the top management of the Islamic Banks. The most important aspect in functioning of this department is a strict commitment to sound banking practices: adherence to self-established red line that apply to both the department and top management, diversification of invested assets, choice of investment opportunities, maintenance of appropriate equities/asset ratio and creation of necessary reserves to stabilize the distribution rates to the Mudarabah account holders and to shareholders.

Providing Humanitarian and Social Services

Integration with its local environment and the community is an important factor of success for the Islamic Banks. This must be a more emphasized characteristic of Islamic Banks than their conventional counterpart. The social and humanitarian responsibilities of Islamic Banks are, no doubt, higher than their convention counterpart because of the moral values and societal ideals to which they adhere aside from the ones obligated by compulsory Zakah, Qardh Hasan (interest free-loans), and conformity Shari'ah.
Therefore, there is an important need for Islamic Banks and their Shari'ah boards for awareness and reconsider their present approaches and behaviors if they want to provide outstanding service to their customers and consequently gain their confidence and continued growth of the bank.60

2.3.7 Risk Management

Risks are part of financial intermediation. The survival and success of a financial organization depends on the efficiency with which it can manage its risks. Risk management is one of the critical factors in providing better returns to the shareholders. It is also essentially for stability of the overall financial system. This is necessity to understand several risks related with Islamic finance in general and Islamic Banking products in particular. Enhancing complexity and convergence of financial activities has resulted in multiplicity of risks. The four most common forms of risks are credit, market, liquidity and operational. The Islamic financial industry has a different orientation towards risks. The risks are more aligned on the basis of contract types as result of the special structuring of the contracts in Islamic Banking.61

Risks in Islamic Banks

As Islamic Banking is rather new, the risks inherent in the instruments used are not well comprehended. Islamic Banks can be expected to face two types of risks:

1. Risks that are similar to those faced by traditional financial intermediaries and
2. Risks that is unique owing to their compliance with the Shari’ah.

Furthermore, Islamic Banks are constrained in using some of the risks mitigation instruments that their conventional counterpart used.

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61Ionnis Akkizidis and Sunil Kumar Khan Delwa, No.37, p.28.
The asset and liability sides of Islamic Banks have unique risk characteristics. The Islamic Banking model has evolved to one-tier Mudarabah with multiple investment tools. On the liability side of Islamic Banks, saving and investment deposits take the form of profit sharing investment account. Profit and loss sharing is the nature of some of the Islamic financial contracts, along with the changing relationships of parties during the lifetime of the contract. These expose them to specific types of risks. These risks are specific to the contract types. These instruments on the asset side, using the profit-sharing principle to reward depositors, are a remarkable feature of Islamic Banks. Such instruments change the nature of risks that Islamic Banks face. The four most common forms of risks faced by Islamic Banks are discussed below.\(^6\)

### A. Credit Risk

Credit risk is simply defined as the potential that a borrower or counterpart will fail to face its obligation in accordance with agreed terms. It is the risk of failure of the counterpart to honour their commitment, and is also referred to as default risk.\(^5\) Credit risks arise from the volatility in the bank’s net cash flow as a result of an unexpected decline in its total cash flow due to default by counter-party. This can give rise not only to a liquidity crunch but also adversely affect the quality of the bank’s assets. In general, the standing of counter-parties, nature of the legal system, quality of collateral, maturity of credit, size of banking and trading books, utilization of credit derivatives, and internal control systems determine the level of credit risks of bank. Super authorities, therefore, need to be familiar with the several factors that influence the general nature of credit risks to which Islamic Banks are exposed.\(^4\)

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For example, credit risk in Murabahah contracts created in the form of the counter-party defaulting in paying the debts in full and in time. The non-performance can be due to external systematic sources or to internal financial causes or be a result of moral hazard. Sometime, in the case of profit-sharing modes of finance (like Mudarabah and Musharakah) the credit risk will be non-payment of the share of the bank by the entrepreneur when it is due.65

B. Market Risks

Market risks include of interest rate risks, exchange rate risks, and commodity as well as equity price risks. Like conventional banks, Islamic Banks are also exposed to these risks. Interest risk is one of the most significant market risks faced by conventional financial institutions. Since Islamic banks do not deal in interest-based instruments, it has sometimes been argued that these institutions do not face this risk. However, the fact is that Islamic Banks are also indirectly confronted with this risk through the mark-up price of deferred sale and lease-based transactions. Since Islamic Banks use LIBOR66 as benchmark in their financing operations. It is natural for the assets of these Banks to be revealed to the risk of changes in the LIBOR rate.67

Islamic Financial Institutions use a benchmark rate to price different financial instruments. For example, in a Murabahah contract the mark-up is determined by adding the risk premium to the benchmark rate (usually the LIBOR). The nature of a Murabahah is such that the mark-up is fixed for the duration of the contract. Consequently, if the benchmark rate

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65M. Kabir Hassan, Mervyn K. Lewis, No. 64, p. 145.

66The London Interbank Offered Rate (LIBOR) is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the London wholesale money market (or interbank lending market). Alternatively, this can be seen from the point of view of the banks making the ‘offers’, as the interest rate at which the banks will lend to each other: that is ‘offer’ money in the form of a loan for various time periods (maturities) and in different currencies.

67M. Umer Chpar, Tariqullah Khan, No. 65, pp. 54-55.
changes, the mark-up rates on these fixed income contracts cannot be adjusted. As a result Islamic Banks face risks arising from movements in market interest rate. Mark-up risk can also appear in profit-sharing modes of financing like Mudarabah and Musharakah the profit-sharing ratio depends on, among other things, a benchmark rate like LIBOR.⁵⁸

Conventional banks try to operate interest rate, exchange rate, and commodity and equity price risks by using futures, forwards, options and swaps contracts. However, no agreement has yet been taken place among the jurists (Fuqaha) on the permissibility of these instruments. It has, therefore, not been possible to design Shari'ah compatible substitutes for the conventional risk management instruments.⁶⁹

C. Liquidity Risks

Liquidity risks arises from either difficulties in obtaining cash at reasonable cost from borrowing (funding liquidity risk) or sale of assets (asset liquidity risk). The liquidity risk arising from both sources is critical for Islamic Banks. For a number of reasons, Islamic Banks faced serious liquidity risk.

First there is Islamic law restriction on the securitization of the existing assets of Islamic Banks, which are predominantly debt in nature.

Second because of slow development of financial instruments, Islamic Banks are also unable to raise funds quickly from the markets.

Third, the Lender of Last Resort (LLR) provides emergency liquidity facility to banks whenever needed. The existing LLR facilities are based on interest, therefore Islamic banks cannot benefit from these.⁷⁰

⁵⁸M.Kabir Hassan, Mervyn K. Lewis, No.63, p.145.
⁶⁹M.Umer Chpar, Tariqullah Khan, No.65, p.55.
⁷⁰M.Kabir Hassan, Mervyn K. Lewis, No.63, p.145.
The liquidity risk faced by Islamic banks seems to be low at present because of the excess liquidity syndrome that these Banks face as a result of the non-availability of adequate Shari’ah-compatible investment opportunities. Nevertheless the Islamic Banks have so far not faced any liquidity problem. This has been a double-edged weapon because while it has saved the Banks from liquidity crises, it has also led to the lack of development of formal liquidity management instruments. These problems are, however, are not impossible to be solved. They can, and will be, resolved with the passage of time with the cooperation of banks, the jurists (Fuqaha) and the central banks.\footnote{Umer Chpar, Tariqullah Khan, No.65, p.56.}

**D. Operational Risks**

Operational risk is explain as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.\footnote{Bank for International Settlement, Basel Committee of Banking Supervision, *International Convergence of Capital Measurement and Capital Standard* (Basel, Switzerland, 2006), p.144.} The three major components of operational risk are people, processes, technology, or some other external events. People’s risks include human errors, lack of expertise, incompliance, and fraud. Process risks include risks related to different aspects of running a business, which may compose regular business processes, risks related to new products and services, inadequate/insufficient control, etc. Failures related to system are included in technology risks.\footnote{Ionnis Akkizidis and I, No.39, p.34.}

In addition to these risks, the Islamic Banks also face substantial Islamic law-related risks arising from the non-standardized nature of some Islamic Banking products. Moreover, an efficient and prompt Shari’ah litigation system is not in place, and banks as well as supervisory staff are not well-oriented in the knowledge of Fuqaha (jurist). The Shari’ah supervisors are also not well-experimented in the implications of modern risk management.
concepts. This has had the effect of discourage Islamic Banks of utilization of many genuine risk management concepts and systems which may not necessarily be in conflict with Shari’ah.  

However, Islamic Banks face additional risks due to the nature of their balance sheet and Shari’ah compliance. Non-availability of financial instruments to Islamic Banks is a major hindrance in their way to operate market risks as compared to the conventional banks. While some of the Islamic law-related issues have to be resolved by Shari’ah scholars, setting up of infrastructure institutions requires to be done by the government and regulatory authorities in different countries.

Therefore, there is a need to introduce a risk management culture in Islamic Banks. One way to introduce this culture is initiate some form of internal rating system. Specifically, risk weighting of all their assets separately is needed. In the medium and longer-run these could develop into more sophisticated systems. Initiation of such a system can be instrumental in filling the gaps in the risk management system and hence increasing the rating of these by the regulatory authorities and external credit assessment agencies.

2.4 Challenges

Since inception the biggest challenge Islamic Banks have faced is how to narrow the gap between the Islamic Banking model and its application; in other words, between theory and practice. The major challenges Islamic Banking is facing may be explained as follow.

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24 M.Umer Chopar, Tariqullah Khan, No.65, p.56.
26 Monzer Kahf, Ausaf Ahmad and Sami Homud, No.21, p.39.
1. Building Proper Institutional Framework

Building a proper institutional establishment is perhaps the most serious challenge for Islamic Banks. To face this challenge, a “functional approach” towards building this set-up should be adopted. The functions being conducted by various institutions in the conventional framework should be examined and attempts should be made of establish institutions that can conduct those functions in an Islamic way.

2. Increased Competition

This development is clearly the viability of Islamic Banking as an alternative model but at the same time, it has increased competition. In general, competition is supposed to be good for the growth of any industry. It improves inefficient firms to either shape up or shape out. It reduces the costs and improves services to consumers. It encourages innovation and brings improvements in product quality.

3. Building Bridges and Strategic Alliance

Islamic banks cannot remain alone of these developments. They must carefully watch these developments and adjust their strategies accordingly. In order to operate in global markets, they have to enhance the size of their operations as well as form strategic alliances with other banks. It will also be useful to build bridges between existing Islamic banks and those conventional banks that are interested to do banking on Islamic principles. Such strategic alliances will benefit both sides.

4. Need to Increase the Size of Islamic Banks

The small size of Islamic Banks is also a major factor for lack of portfolio diversification. Resources at their arrangement are not sufficiently large to minimize risk through portfolio diversification. In order to increase the level of efficiency and deal more
effectively with financial markets, it is desirable that the size of operations of Islamic Banks be substantially increased. In this regard, serious consideration should be given to mergers.\textsuperscript{77}

5. Financial Engineering

Financial markets are now becoming more and more complicated. In order to exploit the fast changing market environment and face increasing competition, financial engineering and innovation is imperative. The financial needs of both individuals and businesses, however, have now changed. The Financial Engineers in modern finance have planned several new instruments such as options, derivative, hedging, insurance, pension plans, credit cards and new mortgage products to meet these instruments.

6. Shari'ah Aspect

However, because of the religious aspect of Islamic Banking and finance, no new product can be adopted until it is cleared by Shari'ah scholars. Even after a new product is put into practice, Shari'ah auditing of the operations of financial institutions is very important to ensure that the actual practice are in accordance with the compliant of Shari'ah. This is important not only for religious reasons but also for purely business considerations because the clients of Islamic Banks will not have confidence in their instruments unless Shari'ah scholars clear their activities.\textsuperscript{78}

7. Teaching, Training, Research and Development

Teaching, Training and Research are the where-with-all for the development of any regulation. This is more so for a regulation like Islamic Banking and Finance, which is still beginning. Another very important component for useful and scientific research is

\textsuperscript{77}Munawar Iqbal, Ausaf Ahmad, Tariqullah Khan, No.4, pp.63-65.
\textsuperscript{78}Munawar Iqbal, Philip Molyneux, No.7, pp.107-108.
the availability of reliable information. This has not received much attention from Islamic Banks. Islamic Banks have spent a sizeable amount on research and development. There is a need to enhance efforts in this area to several times the current levels.

8. Fixed Versus Variable Return Modes of Finance

Islamic finance system has presented a number of financial instruments. Broadly speaking, they may be divided into fixed-return and variable return or profit sharing modes. There are many reasons why the fixed-return modes have become more popular in practice. They have a number of desirable features such as simplicity, convenience and safety. They are providing banks high liquidity with low risk. It may state that the fixed-return modes of finance being used by Islamic Banks are clearly different from interest-based modes. Transactions of the former modes are always done through real transactions, while in the latter case they are carried through inter-temporal exchanges of money.74

9. Conditions of Participation in Equity markets

In all businesses there is need for long-term finance, in a conventional system this is provided through long-term bonds and equities. This function is conducted by securities markets and specialized equity institutions. In addition to the general public, the most significant sources of these investments are investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not involve with interest-bearing bonds and therefore the need for equity markets is much higher in an Islamic framework. It may be mentioned here that even in conventional finance, there is an increasing trend towards the use of equities as a sources of business finance. Islamic financial institutions need to

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74 Munawar Iqbal, Ausaf Alamad, Tariqueh Khan, No.4, pp.66-68.
be involved in equity markets. However, there are some unresolved fiqh issues that are
hampering this trend and these issues needs to be resolved as soon as possible.  

10. Appropriate Legal Framework, Policies and Procedure

An appropriate legal, institutional and tax framework is a basic requirement for
establishing sound financial institutions and markets. Islamic jurisprudence offers its
own framework of the instrument of commercial and financial contracts and
transactions. Conventional banking laws also narrow the gap of activities of Islamic
Banking within conventional limits. In the absence of Islamic Banking laws, the
enforcement of agreements in courts may need extra effort and costs. Therefore,
banking, property and company laws in several countries require a suitable modification
to provide a level playing field for Islamic Banks. 

11. Supervisory Framework

In most countries Islamic Banks are based on the supervision of the central bank of the
country. Most of Islamic Banks in the contemporary world perform in a mixed
environment in which interest based banks function side by side with the Islamic Banks.
The central banks subject the Islamic Banks to the same controls, conditions and
regulations that they adopted to interest based banks. However, there are certain factors,
which require that Islamic Banks should be treated on a different standing point.

2.4.1 Prospective

Where Islamic Banking needs to go: the way ahead. The commendable achievements
during the last 30 years do not mean that all is well with Islamic Banking. While many of

\[\text{\textsuperscript{80} Munawar Iqbal, Philip Molyneux, No.7, pp.105-106.} \]
\[\text{\textsuperscript{81} IRTI, IFSB } \textit{Islamic Financial services Industry Development Ten-Year Framework and Strategies} \text{ (Jeddah: IRTI, 2007), p.23.} \]
\[\text{\textsuperscript{82} Munawar Iqbal, Ausaf Ahmad, Tariqullah Khan, No.4, p.70.} \]
these are result of the inappropriate environment in which Islamic Banks are working, there are others which have arisen from the practices of Islamic Banks themselves. It can be explained how in our view the Islamic Bank and finance industry needs to respond to those challenges as it enters the twenty-first century.

1. The Need to Broaden Base

The ownership structure of the Islamic financial industry is highly concentrated. Three or four groups own a large percentage of the industry. This concentration of ownership could result in substantial financial instability and possible collapse of the industry if anything happens to those groups, or the next generations of these groups change their priorities. This popular support needs to be converted into grassroots involvement in Islamic Banking, both in terms of ownership as well as beneficiaries of bank financing. Going from non-interest financing to profit-sharing financing, or a more balanced combination of the two, is the next milestone that the Islamic banking industry should head toward.

2. The Need for Diversification in the Use of Islamic Mode of Finance

Islamic financial transactions are of two kinds. One is based on a fixed charge on capital, and the other is based on profit-sharing which does not guarantee any rate of return. Both kinds provide finance through the purchase and sale of real commodities. Islamic Banking specialist built up their hopes on Islamic Banks to provide a significant amount of profit-sharing finance and would be expected to produce a strong economic development impact. Some scholars have argued that is one of the most serious problems facing Islamic Banking as an alternative model which is distinguished by risk sharing.

"We cannot claim, for an interest-free alternative not based on sharing, the superiority which could be claimed on the basis of profit sharing. What is worse, if the alternative in practice is built around predetermined rates of

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83 Munawar Iqbal, Philip Molyneux, No. 7, pp. 123-129.
return to investible funds, it would be exposed to the same criticism which was directed at interest as a fixed charge on capital. It so happens that the returns to finance provide in modes of finance based on Murabahah, Bai al salam, leasing and lending with service charge, are all predetermined as in the case of interest.  

3. Preparing for Increased Competition

So far, Islamic Banks have had a fairly degree of monopoly over the financial resources of the Islamic-ally-motivated public. This situation is changing fast and Islamic Banks had better prepare for a global market. Islamic Banks are now facing ever-increasing competition. An important development in Islamic banking in the last few years has been the entry of some mega-international banks into the Islamic financial industry. The competition from conventional banks is expected to increase further in the near future due to globalization. Due to liberalization, the world markets are rapidly converging into a single market place. To benefit from the opportunities offered by globalization, the Islamic Banks need to improve the quality of their services and develop suitable products. Technological innovations are also playing an important part in financial integration and globalization. Globalization of financial markets has led to more and more integration of capital markets. Liberalization of foreign exchange markets has further reinforced this trend. Islamic Banks cannot remain aloof from these developments. They must carefully watch these developments and adjust their strategies accordingly.

4. The Need to increase the Size of Islamic Banks

In the light of technological changes and globalization, Islamic Banks must improve themselves to operate a much larger size of operations and to deal with internationally-minded and financially sophisticated customers. The required infrastructure and the larger and geographically wider scope of operations need for larger bank size. As against this, the

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85 Munawar Iqbal, Ausaf Ahmad, Tariqullah Khan, No.4, pp.55-56.
available data show that Islamic Banks and financial institutions are relatively small and below the optimum size, as is clear from the following facts:

1. If the Asset of all Islamic Banks were mobilized, they would still be less than those of any single bank in the top 50 banks in the world.
2. The Assets of the largest Islamic Bank are equal to only 1 percent of the assets of the largest bank in the world.

5. The Emerging Shape of Financial Firms

Until a few years ago, there was a shape distinction between bank and non-bank financial intermediaries. On one hand, banks were not allowed to invest in stock markets; on the other hand, non-bank financial institutions were not allowed to have current account. Even the most famous law in this regard, the Glass-Steagall Act in the USA, has been replaced. A free market approach to integrated financial service provision which will allow affiliation among all financial and non-financial companies has become popular in Europe, the USA and Japan, and may soon be enacted in many other countries. Removal of barriers in the areas of their operations is bringing banks and security firms into direct competition. This is bound to change the profile of financial firm in the twenty-first century. Islamic Banks are in a distinctly advantageous position in this regard, because they are supposed, by construction, to take part in direct investment and trade. In order to take advantage of new opportunities and to face competition they have to find ways and means to overcome their inhibitions and move towards a universal banking model.\textsuperscript{86}

2.4.2 Present state

Islamic finance is growing as a source of finance for Muslims and other investors around the world. The global market for Islamic financial services, as measured by Shari'ah

\textsuperscript{86} Munawar Iqbal, Philip Molyneux, No.7, pp.131 -132.
compliant assets, is estimated by the UK Islamic Finance Secretariat (UKIFS) to have reached $1,130bn at end-2010, 21% up on $933bn in 2009 (Figure 2.3).

Figure 2.3: Global Asset of Islamic Finance

Assets are likely to have grown a further 14% in 2011 to reach $1,289bn, making a rise of about 150% from $309bn in five years since 2006. Islamic assets represent about 1% of the global financial market. The largest centres remain concentrated in Malaysia and the Middle East, including Iran, Saudi Arabia, UAE, Kuwait, Bahrain and Qatar.

Figure 2.4: Islamic Finance by Country
Indonesia has the largest Muslim population in the world at an estimated 205m and Bangladesh the fourth largest at 149m; India and Pakistan make up the other two countries with the largest Muslim population each with around 177m. These four countries account for 44% of the worldwide Muslim population of 1.6bn (figure 2.6).

Figure 2.6: Muslim Population by Country
More countries are looking to expand the Shari'ah offering. New Shari'ah compliant institutions have been reported by The Banker, for example Australia, Azerbaijan, Nigeria, Oman, Pakistan, Qatar and Russia. Oman is the last of the Gulf Co-operation Council (GCC) states to open the door to Islamic Banks. Leading countries for Islamic finance should provide fertile ground for future growth, although the long-term impact of political unrest on development of Islamic finance in some Middle Eastern countries, such as Egypt, remains to be seen.

**Global Market for Islamic Finance**

As mentioned in the overview, UKIFS estimates that the global market for Islamic financial services, as measured by Shari'ah compliant assets, reached $1,130bn at end-2010, 21% up from $933bn in 2009. It is likely to have grown a further 14% in 2011 to reach $1,289bn, making a rise of about 150% from $509bn in five years since 2006. Assets that can be allocated to individual countries from The Banker’s survey of 500 organizations reveal that the leading countries for Shari'ah compliant assets are Iran with $388bn, Saudi Arabia $151bn and Malaysia $133bn. These are followed by other Gulf States including UAE, Kuwait, Bahrain and Qatar, and then Turkey. The UK, in ninth place, is the leading Western country with $19bn of reported assets, largely based on HSBC Amanah. Countries with most of the 345 firms reporting to The Banker’s survey include Kuwait and Malaysia, each with 39 firms, and Bahrain with 33 firms. A group of countries including Indonesia, Iran, Saudi Arabia, Pakistan, UAE and the UK each have between 20 and 27 firms supplying Islamic finance. (Figure 2.7)
Shari'ah Compliant Financial Services

Banking and Sukuk represent the forms of Islamic finance that are most well established, with Takaful (insurance) and funds also developing. Products that may be the subject of innovation include private equity and private wealth management. Banking in the Banker’s survey, balance sheet assets of Shari'ah compliant banks rose by 22% from $863bn in 2009 to $1,048bn in 2010. Commercial banks account for the majority of assets, with investment banks making up most of the remainder. Ernst & Young has indicated that profitability of banks in the Middle East and North Africa stabilized in 2009 and 2010 having suffered in previous years due to higher provisions and operating costs. Considerable potential for expansion exists with The Banker estimating that only 12% of Muslims use Islamic products, although scope is more limited in countries where Muslims represent a minority. Extent of the industry’s penetration varies substantially. In Bangladesh Islamic banking accounts for 65% of total banking assets; in Bahrain 46% and Saudi Arabia 35%.
However penetration in other countries is limited with Islamic Banking accounting for only 4% to 5% of total banking assets in Turkey, Egypt and Indonesia. (Figure 2.8)

Figure 2.8: Islamic Finance Penetration in Selected Countries

Islamic banks, including those with Islamic 'windows', are now looking to enhance their position in faster growing core regions of Middle East, Asia and Africa. Offering products that are competitive on price and service could help to generate business not only from Muslims with a preference for Shari'ah compliant services, but also from Muslims and other customer that currently use conventional banking services. 87