ISLAMIC BANKING: STATE OF THE ART

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This paper reviews the progress of Islamic banking from both theoretical and practical aspects. It highlights the basic principles on which Islamic banking is based and describes the operational details of Islamic banks. It mentions some of the misgivings with respect to the viability of Islamic banking and evaluates them objectively. It highlights the effects of Islamic banking on savings, investment, growth, allocative efficiency and stability. The paper also reviews and evaluates the practice of Islamic banking both at the level of individual banks as well as country level experiences in Pakistan, Iran and Sudan. At the end, the paper identifies areas where further research is needed.

.1INTRODUCTION

The term "Islamic banking" means conduct of banking operations in consonance with Islamic teachings. Banking practices which involve the receipt and payment of interest are not compatible with the teachings of Islam. Yet it is a fact of life that the Muslim societies were unable to keep away from interest based transactions when modern banks appeared on the scene. The Islamic banking movement, which has been gathering momentum in recent years, seeks to change this situation. This movement has two dimensions. On the one hand, theoretical work is being undertaken on various aspects of interest free banking. On the other hand, practical experience is being gained in running interest free banks and financial institutions. A good deal of interaction is also taking place between the theory and practice of Islamic banking. The Islamic banking movement is still in its infancy but it has already made a significant impact on the world financial scene.

The aim of this paper is to review and assess the present state of the art in Islamic banking both in its theoretical and practical aspects. In the next section, we review the main developments in the theory of Islamic banking. The third section analyses the trends witnessed in the actual practice of Islamic banking in various parts of the world. The final section draws attention to certain issues which need further study and research in the light of the practical experience gained so far in the field of Islamic banking.

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.2THE THEORY OF ISLAMIC BANKING

The theory of Islamic banking is based essentially on the premise that interest , which is strictly forbidden in Islam, is neither a necessary nor a desirable basis for the conduct of banking operations, and that Islamic teachings provide a better foundation for organizing the working of banks. Muslim economists have pointed out that it is a historical accident that interest has become the kingpin of modern banking. The practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions. Aristotle dwelt on the "barren" nature of money and vehemently condemned the institution of interest which he described as "birth of money from money". Under Judaism, Israelites were forbidden to demand any increase on the principal amount of the sum lent in transactions among themselves, though interest could be charged in dealings between Israelites and gentiles. The reason for this distinction, according to many scholars of Judaism, was that there was no law at that time among the gentiles which prohibited the practice of interest, and it was not regarded as unfair that Jews be allowed to recover interest from people who charged interest from them. In Christianity, the reported saying by Christ to "lend freely, hoping nothing thereby" (Luke 6:35) is taken by many commentators as condemnation of interest. However, the Church gradually changed its doctrine on the subject of interest. In any case, the divorce between religion and mundane affairs accepted by Christian societies after the reformation opened the door for widespread practice of interest .Among the followers of Islam, the institution of interest has always been regarded as highly ignoble because the Holy Qur'an strictly prohibits interest based transactions in all forms. In the early history of Islam the injunction relating to prohibition of interest was strictly observed, but with the decline of the hold of religion and spread of Western influence, financial practices based on interest began to permeate Muslim societies as well. In the period of colonial domination of Muslim countries by Western powers, the interest based system became solidly entrenched. It is this string of historical circumstances, Muslim scholars argue, which has led to the present-day dominance of interest in financial transactions all over the globe. Had the societies developed in a different fashion and paid greater heed to the injunctions of religion, the development of the financial system would have surely taken a different course, and we could have had in actual operation an alternative system free of interest but fully meeting the needs of modern society.

Muslim scholars recognize the important role banks play in the economy of a country in modern times. Banking institutions act as financial intermediaries between savers and investors. They can be of significant help in assisting the process of capital formation and development. There was no prototype of modern banks in the early history of Islam. Even in Western countries, banking in the form in which it exists today is of comparatively recent origin. Before the advent of modern banking, direct finance, where the owner of capital deals directly with the user of capital, was the customary mode of transference of funds from savers to investors. With the progress of trade and industry and increased financing requirements of productive enterprises, direct finance proved an inadequate mechanism for such transference and banks emerged on the scene to undertake financial intermediation between savers and investors. The attitude of Islam to all known innovations is that nothing should stand in the way of their adoption if they are useful for human society and do not conflict with the fundamental teachings of the Qur'an and the Sunnah. Since banks perform a useful service of financial intermediation, they are wholly acceptable in a Muslim society. What is not acceptable, however, from the *shari'ah* point of view, is the use of interest rate mechanism in the process of financial intermediation.

For long Muslims the world over were beset with a dilemma. Islam prohibits the giving and taking of interest while it looked almost impossible to steer clear of interest in the modern world where interest played a key role in most of the financial transactions. The contemporary Islamic resurgence has begun to provide an answer to this dilemma. Theoretical work by Muslim scholars has sought to demonstrate that it is possible to run an economy without interest even in modern times. Replacement of interest based banking by interest-free banking has received the greatest attention in this endeavor.

The basic postulate that has guided all theoretical work on Islamic banking is that while interest is forbidden in Islam, trade and profit is permissible. Conventional banking uses the interest rate mechanism to perform its task of financial intermediation. Muslim scholars have developed a radically different model of banking which does not make use of interest. It relies instead on profit/loss sharing for purposes of financial intermediation. The earliest references to the reorganization of banking on the basis of profit/loss sharing are found in the writings of certain Muslim scholars in the late forties and early and mid-fifties of this century. The sixties and seventies saw more elaborate formulations of the concept of Islamic interest free banking. The subsequent period has witnessed further refinements in the theory of Islamic banking.

Theoretical work on Islamic banking encompasses several aspects related both to the operating procedures of Islamic banks and the possible socioeconomic consequences of the adoption of the new system. In this section of the paper we shall review the main contributions to the theory of Islamic banking under the following broad heads:

a(The concept and models of Islamic banking;
b(viability of Islamic banking, and
c(socioeconomic consequences of Islamic banking.

2.1The Concept and Models of Islamic Banking

The theoretical work on the concept of Islamic banking has proceeded on the basis that guidance for all institutionalized developments in an Islamic society should be derived from the principles of *shari'ah* .The form and content of Islamic banking practices have, therefore, to be derived from the teachings of Islam. Scholars in search of a new form of banking which should steer clear of interest noted that though banks did not exist in the early Islamic period, the practice of financial resources of one party being used by another party in the conduct of business, trade or industry was fairly widespread. In the pre-Islamic period, all financial resources were mobilized on the basis of either interest or some sort of profit/loss sharing arrangements. Islam prohibited all dealings based on interest but allowed the continuance of the system of profit/loss sharing. The two forms of profit/loss sharing which were predominantly in use in the pre-Islamic period are known as *mudarabah* and *musharakah* .In *mudarabah* ,one party provides the capital while the business is managed by the other party. Profit is shared in pre-agreed ratios and loss, if any, unless caused by the negligence or violation of the terms of the agreement, is borne by the provider of capital. In *musharakah* ,partners pool their capital to undertake business. All providers of capital are entitled to participate in management but are not necessarily required to do so. Profit is distributed among the partners in pre-agreed ratios while loss is borne by each partner strictly in proportion to the respective capital contribution. The jurists of the early Islamic period closely examined the features of *mudarabah* and *musharakah* as found in the pre-Islamic period and built a corpus of juridical opinion in regard to the attributes that must be possessed by these two types of financial arrangements to make them fully compatible with the ethos of the value system of Islam. The wealth of *fiqh* literature on the subject has been of invaluable help in devising models of Islamic banking capable of functioning on truly Islamic lines in the modern age.

In developing models of Islamic banking, scholars of recent times have tried to follow as closely as possible the precepts of the highly respected jurists of the early Islamic period. However, in matters on which the Qur'an and the Sunnah provide no specific injunctions they have, where necessary, departed from some of the opinions of *fuqaha* of the early Islamic period in order to find practical solutions to modern day problems. This is fully in consonance with the objectives of the *shari'ah* and aids the growth of Islamic jurisprudence to meet the challenges of the modern age.

The efforts of Muslim scholars in developing models of banking within the parameters of Islamic teachings had led to a variety of proposals. It is not intended to survey here the various individual contributions in the field; a good review of several such contributions is available elsewhere [1].It will suffice, for purposes of this paper, to note the salient features of these models .

The hard core of almost all Islamic banking models developed so far is a two-tier *mudarabah* contract, the first among the depositors and the bank, and the second between the bank and the parties to whom finance is provided. The earliest contributions on the subject were of the nature of summary proposals and had very few details. With the passage of time, increased attention has been given to the details of the operating procedures of Islamic banking, imparting greater degree of realism to the theoretical models.

The earlier Islamic banking models envisaged three main sources of funds for Islamic banks and four principal uses of these funds. The three sources of funds were identified as (i) the bank's share capital (ii (*mudarabah* deposits, and (iii) demand deposits. The four principal uses of these funds were identified as (i (*mudarabah* financing (ii) financing on the basis of the principles of *musharakah*) iii) purchase of ordinary shares of commercial or industrial enterprises as well as any investment certificates issued in the private or public sector on profit/loss sharing basis, and (iv (*qard al-hasanah* .Later models took cognizance of the fact that Islamic banks may need to branch into certain other activities to deploy their funds. The theoreticians noted that in the actual practice of Islamic banking, a number of Islamic banks which had started operating in the seventies in different countries did not confine their activities to only the four modes of finance envisaged in the earlier theoretical models. The *shari'ah* experts associated with the working of these banks saw no objection to banks engaging in activities like *murabahah*) a contract in which a client wishing to purchase equipment or goods requests the bank to purchase the items and sell them to him at cost plus a declared profit ,(*bai muajjal*) a trade deal in which the seller allows the buyer to pay the price of a commodity at a future date in lump sum or installments ,(*ijara*) leasing ,(*ijara wa iqtina*) hire purchase) and *bai salam*) advance cash purchases of products). Similarly, banks could also engage in actual conduct of business either on their own or through their wholly owned subsidiaries. The later models of Islamic banking make specific mention of such activities. This represents a concrete example of the interaction between the theory and practice of Islamic banking.

While delineating the operating procedures of Islamic banks, the theoretical models of Islamic banking have given special attention to the principles governing the allocation of profits between the banks and the *mudarabah* deposit holders and between the banks and the users of bank funds under profit/loss sharing arrangements. In most of the earliest models, shareholders' equity and *mudarabah* deposits were deemed to be the only two remunerable liabilities of an Islamic bank, and holders of *mudarabah* deposits were treated as one homogeneous group. The profit sharing arrangements between these two broad groups of providers of capital were envisaged along the following lines:

a)The aggregate profit earned by the bank on the total capital will be divided over it. After such a division, an agreed proportion of the profit will be kept by the bank and the rest will be given to the holders of *mudarabah* deposits. The proportion of profit division will be determined with the mutual consent of the two parties concerned.

b)If the bank suffers a loss, the loss will be shared between the two parties in strict proportion to the capital supplied by each party .

c)The maximum incidence of loss to a *mudarabah* deposit holder in a loss situation will be limited to the amount of his deposit.

In later contributions to the literature on Islamic banking, it was recognized that profit sharing arrangements among the remunerable liabilities of an Islamic bank could take more complex forms while still remaining within the *shari'ah* parameters. It was felt that there was a strong case for some flexibility in profit sharing ratios depending upon the degree of risk to which various types of remunerable liabilities were exposed. The *mudarabah* deposits of a longer maturity could be given an edge over deposits of shorter maturity in the profit sharing arrangements. Similarly a distinction could be made between the providers of redeemable capital and non-redeemable capital, with provision of larger return to providers of non-redeemable capital.

As for the profit sharing arrangements between the bank and the users of bank funds, Islamic banking models stick to the basic principle laid down in the *shari'ah* that profit earned from *mudarabah* business will be distributed between the provider of funds (the bank) and the user of bank funds on the basis of proportions settled in advance. No fixed amount can be settled for any party. Loss, if any, unless caused by negligence or violation of the terms of the contract by the user of bank funds, will be borne by the provider of funds. For the purpose of profit/loss sharing in *musharakah* business, the respective capital contributions of parties, utilized for varying periods, would be brought to a common denomination by multiplying the amounts with the number of days during which each particular item such as equity capital of a firm, its current cash surpluses, suppliers' credit as well as the finance provided by the bank were actually deployed in the business. In other words, the calculation of the respective capital contributions of the parties would be made on a daily product basis.

A prominent feature of Islamic banking models is the relegation of loans and advances to a very minor role whereas they play a dominant role in the assets structure of the interest based banks. This is for the simple reason that no return is allowed on loans and advances in the Islamic system whereas in the conventional system they are high return assets. The use of lending is confined mainly to help meet the needs of those who are unable to secure financing facility in any other way.

While profit/loss sharing is the central feature of almost all the Islamic banking models developed so far, differing viewpoints have been expressed by various writers on certain aspects of the working of Islamic banks. The more important of these are indicated below:

a)It has been suggested that Islamic banks should draw a sharp distinction between money deposited as demand deposits and money deposited in *mudarabah* accounts. Demand deposits should be backed by 100 percent reserve as they are of the nature of an *amanah*) safe keeping [2].(This view is not shared by others who regard demand deposits as *qard al-hasanah* deposits whose repayment in full on demand is guaranteed by the bank but these can be used by the bank in its financing operations.

b)Some writers are of the view that Islamic banks should not resort to credit creation [3]. They feel that credit creation enables banks to reap unjustified profits which go to enrich a limited class of population. Others see no objection to credit creation by the Islamic banks and are of the view that means can be found to ensure that the benefits from the totality of banking operations are equitably distributed.

c)Some writers are of the view that for Islamic banks to really work in the Islamic spirit it is necessary that they should be small localized institutions .[4]They feel that Islamic banks should be a decentralized chain of institutions sharing the features of a local bank, cooperative society and a social service organization. Others do not go to this extreme but seem to be against big sized banks to prevent them from exercising undue power .[5]Most other writers are of the view that Islamic banking can be practiced according to its underlying spirit irrespective of the size of the banks.

d)Some writers have suggested that Islamic banks should be required to earmark a certain part of their demand deposits for providing interest-free loans to the government to enable it to finance socially beneficial projects for which the required financing cannot be secured on profit sharing basis [6]. The rationale for this is that since the funds available to a bank through demand deposits belong to the public and the banks do not pay any return on these deposits, a part of these should be utilized for meeting the financial needs of the government. Similarly it has been suggested that a part of demand deposits may be utilized for making interest free loans for meeting genuine consumption requirements of the people [7].Others are of the view that provision of interest free loans to the government should be undertaken by the central bank of the country rather than the commercial banks. A number of writers have expressed the view that commercial banks should not be involved in financing the consumption requirements of the people. They think that *zakat* funds should be used for meeting the consumption requirements of the really needy persons while others should be motivated to set up cooperative self-help bodies to finance the consumption requirements of individual members as the need arises.

The literature on Islamic banking does not deal only with the mechanics of Islamic banking. It delves deep into the philosophy of Islamic banking. It has been pointed out that the monetary and banking system of a country does not operate in an ideological vacuum. It is an integral part of its parent ideology. Its operating procedures have to be fashioned in accordance with the requirements of a particular ideology. Judged in this perspective, the task of the replacement of conventional banking by Islamic banking does not consist of a mere mechanical replacement of interest by non-interest modes of financing. These modes have to be chosen keeping in view the religious prescriptions as well as the ideological orientation of an Islamic society. Further, the financing activities of Islamic banks have to be directed towards achieving the Islamic socioeconomic objectives. These objectives briefly are promotion of a pattern of growth best suited to eradication of poverty, equitable distribution of income and wealth and sufficient opportunities for gainful employment.

An important policy issue that has been discussed extensively in the above context is whether keeping in view the Islamic teachings and Islamic socioeconomic objectives, the Islamic banks should have a preference pattern with respect to various modes of financing which are permissible in *shari'ah* .It has been forcefully argued by a number of writers that the real substitute of interest in an Islamic financial system is the mode of profit/loss sharing along with *qard al-hasanah* while the other techniques like *murabahah* ,*bai muajjal* ,*ijara* and *ijara wa iqtina* cannot be of equal significance in achieving Islamic socioeconomic objectives [8].The reasoning employed is as follows. The interest system is disallowed by Islam because intrinsically it is a highly inequitable system. The feature that makes the interest system inequitable is that the provider of capital funds is assured a fixed return while all the risk is borne by the user of these capital funds. Justice, which is the hallmark of the Islamic system, demands that the provider of capital funds should share the risk with the entrepreneur if he wishes to earn profit. It follows, therefore, that financing techniques like *murabahah* ,*bai muajjal* ,*ijara* and *ijara wa iqtina* ,which involve a pre-determined return on capital, cannot be regarded as commendable substitutes for interest, and should only be used when absolutely needed.

These writings have also emphasized that Islamic banking is expected not only to avoid transactions based on interest, but also to participate actively in achieving Islamic socioeconomic objectives of eradication of poverty, achievement of an equitable pattern of income distribution and generation of maximum employment opportunities. It has been argued that these objectives can best be achieved through the profit/loss sharing techniques of *mudarabah* and *musharakah*.

The literature on Islamic banking also encompasses central banking and monetary policy. It has been emphasized that, in the initial stages of the Islamization of a country's financial system, the main task of central banking would be the promotion of an institutional framework necessary for the smooth operation of financial markets in compliance with the rules of the *shari'ah* [9].The central bank would have to play a leading role in the development of new financial instruments for the money and capital markets of an Islamic economy. The new financial instruments that have been suggested in this context include Participation Term Certificates (which would entitle their holders to share in the profits of the concerns issuing them), Specific Investment Certificates (which would carry the name of the enterprise in which the proceeds of the certificates would be invested and in whose profit their holders would share) and Leasing Certificates (which would entitle their holders to a proportionate share in the yield of the assets leased by a company net of administrative expenses [10].(It has also been suggested that the central bank may itself issue a distinctive type of investment certificate and invest its proceeds through the banking system .[11]All these certificates may be issued in different denominations and with different maturities to suit the preferences of various groups of savers. It is envisaged that a secondary market will then develop in which the aforesaid types of primary securities will be sold and resold before maturity, imparting liquidity to such securities and widening the choice of investment media available to savers.

While discussing other responsibilities of the central bank in an Islamic economy, Muslim writers have stressed the need for pursuing monetary policies designed to help achieve Islamic socioeconomic objectives. They have emphasized that monetary policy in an Islamic economy cannot afford to be value neutral. The central bank is expected to make a skillful use of monetary policy instruments available to it to influence the operations of the banking system in such a way that the egalitarian objectives of an Islamic society are achieved with greater ease. A conscientious effort has to be made to ensure that the financing provided by the banks makes a positive contribution to eradication of poverty, generation of maximum employment opportunities and achievement of an equitable pattern of income distribution. Another major responsibility of the central bank is to safeguard monetary stability as both inflation and deflation impose a welfare cost on the society and cause severe hardship to the poorest sections of the population.

Considerable attention has been given in the literature to the modifications that would be needed in the actual conduct of monetary policy when a transition is made from an interest based economy to an interest free economy. In an interest free economy, the central bank will have no use for the traditional monetary policy instrument of changes in the Bank Rate. Open market operations in the traditional sense of the term will also lose their relevance in an interest free framework. Most other monetary policy instruments available to the conventional central banks will, however, remain usable by a central bank operating on non-interest basis. Thus, it will be possible for it to set cash reserve requirements for commercial banks and to vary them as an instrument of monetary policy. It could also impose a liquidity ratio and vary it from time to time in accordance with the needs of the situation. The central bank would also be able to regulate the monetary situation by placing quantitative ceilings on the financing operations of banks. For influencing the flow of bank funds in the desired manner and for encouraging or discouraging the use of bank finance for specified purposes, the central bank will be able to use measures of selective control like restricting the use of bank resources for certain purposes and setting mandatory targets for financial assistance to be provided by banks for stated purposes.

To compensate for the loss of the bank rate weapon, some study groups and scholars have suggested that central banks operating on a non-interest basis may be empowered to vary the profit sharing ratios applicable to various types of financial assistance to be made available by the central bank to commercial banks. In addition, the central bank may be empowered to prescribe maximum and minimum profit sharing ratios for banks in respect of finance provided by them, which may be varied from time to time as the situation warrants [12].Others have not favored these proposals as they feel that any change in profit sharing ratio after it has been written into a contract is not permissible under Islamic legal code [13].However, they would probably not object to changes in profit sharing ratios which apply to future contracts and prescription of a range of differential profit sharing ratios to influence both the overall monetary situation and the pattern of resource allocation.

Regarding open market operations, different opinions have been expressed. Some scholars have ruled out the use of this instrument of monetary policy on account of the absence of a government securities market in an interest free economy. They do not favor open market operations in shares of private concerns for several reasons [14].It is not desirable, they point out, for the central banks to buy and sell the stocks of private sector companies. Besides, variations in the prices of equity-based instruments brought about by central bank open market operations would benefit or penalize the shareholders of companies whose shares are used for this purpose. This will not be equitable and can introduce distortions in the share market. Others, however, do not rule out the possibility of open market operations and propose issuance of variable dividend securities by the central bank related to their profit in which such operations could be conducted.

2.2Viability of Islamic Banking

A good deal of literature on Islamic Banking is concerned with the viability of banking institutions which seek to operate on an interest free basis. Notice has been taken of a number of misgivings expressed about the viability of interest free banking and an effort made to dispel these misgivings [15].The more important of such misgivings can be stated as follows :

a)Because of commitment to share in losses also, Islamic banks working on the principle of profit/loss sharing will be exposed to huge losses leading to their failure and insolvency , b)Islamic banks will experience frequent defaults and loss in their earnings on account of concealment of correct income by their clients which will undermine their stability, and

c)Islamic banks cannot perform all the banking functions on non-interest basis in a world which is dominated by interest based transactions.

Muslim writers have pointed out that the commitment of Islamic banks to share in losses will not necessarily involve them in huge losses leading to their failure and insolvency. Islamic banks are expected to operate on the basis of a diversified investment portfolio so that notwithstanding losses suffered in some individual cases the overall profitability can be maintained on account of the pooling of risks. Losses to banks arise mainly on account of defaults on the part of concerns to whom finance is provided. There is no intrinsic reason why an Islamic bank should experience more defaults in the fulfillment of contractual obligations on the part of its clientele compared to other banks. There are three main elements which are germane to the possibility of defaults viz., the nature of the party to whom finance is provided, the purpose for which finance is provided, and the type of supervision exercised by the banks on the end-use of funds. These elements are essentially the same for an Islamic bank and a conventional bank, and if sufficient care is not exercised in regard to these elements, defaults would arise irrespective of whether the bank concerned follows the traditional banking practices or the principles of Islamic banking. Given prudent management, there is no reason to believe that the incidence of defaults would be greater in the case of Islamic banks compared to other banks. On the contrary one should expect that the incidence of defaults would be less because, on account of their having a direct stake in the profit of concerns to whom finance is provided, Islamic banks would be more vigilant in monitoring the end-use of funds as compared to the traditional banks which attach greater importance to the security pledged against the loans compared to the actual monitoring of the business dealings of their clientele.

The possibility of the stability of Islamic banking being undermined by a tendency on the part of users of bank funds to conceal their true profits has been the subject matter of extended discussion in recent literature. A study on the relative merits and demerits of interest based and PLS (profit/loss sharing) based banking attributes the dominance of interest based banking in the world at large to the problem of existence of the "moral hazard" in PLS based banking even though PLS based banking is superior to interest based banking in several other respects [16].In other writings it is stressed that though the existence of the problem of moral hazard in PLS based banking cannot be denied, its risk potential should not be exaggerated. Even the study just now referred to acknowledges that over time the incentive to cheat would be reduced as loss of reputation would restrict future access to credit markets. Others have pointed out that (a) under-reporting of profits, which is considered as cheating, can be challenged in court in the case of *mudarabah* contract) [17];b) users of bank funds who try to cheat could be blacklisted and denied funds from the banking system as a whole which would serve as a strong deterrent to under-reporting of profit) [18];c) firm specific and project specific contracts can be developed that elicit optimal behavior even in the presence of moral hazard [19];and (d) in cases where the non-disclosure of correct income is due to the complexity of the tax system, corruption in the tax collecting machinery and weaknesses of the audit system, appropriate changes in the tax and audit systems would help in overcoming the problem[20].

Another misgiving about the feasibility of Islamic banking of which note has been taken by Muslim scholars is that Islamic banks cannot perform all their functions on non-interest basis in a world dominated by interest based banking. These scholars recognize that successful conduct of Islamic banking in an international environment which is permeated with interest is of course a big challenge. In the financing of multilateral trade transactions, Islamic banks have to deal with conventional banks. In a number of contributions it has been suggested that ways can be found for the dealings of Islamic banks with conventional banks to be founded on non-interest basis. It has been suggested, for example, that in establishing correspondent relationships with conventional banks, the following procedure could be adopted: (a) The Islamic banks will keep a reasonable amount of cash in their current account with the correspondent banks, (b) The Islamic banks will endeavor to correct a debit balance in their account with correspondent banks as soon as possible, (c) The correspondent bank will not charge any interest on the temporary debit balances of Islamic banks in lieu of its freedom to use the credit balances of Islamic banks profitably without paying any compensation to the Islamic banks, and (d) As partial security, the correspondent bank, while adding its confirmation to import letters of credit, will debit the Islamic banks only with a certain "cash margin" so that Islamic banks need to keep only such credit balances with correspondent banks as are likely to cover the cash margins of the letters of credit and not the whole value of these letters[21].

2.3Socioeconomic Consequences of Islamic Banking

The possible socioeconomic consequences of Islamic banking have been the subject matter of extended discussion in recent literature. The discussion has proceeded mainly on the basis of the presumption that PLS based modes of financing will have a dominant role in the conduct of Islamic banking while the other modes would be used sparingly. The main focus of discussion has been on the possible impact of Islamic banking on savings, investment, rate and pattern of growth, allocative efficiency and the overall stability of the banking and the economic system.

)A) Effects on Savings and Investment

Concerns have been expressed that adoption of an interest free system may have an adverse effect on savings because of increased uncertainty regarding the rate of return [22].Muslim economists have pointed out that standard economic analysis does not yield a definitive conclusion regarding the effect of increased uncertainty of rate of return on the quantum of savings. It has been agreed that the actual outcome would depend on a number of factors such as the form of the utility function and its risk properties, for example, the degree and the extent of risk aversion, the degree to which future is discounted, whether or not increased risk is compensated by higher return, and finally the income and substitution effects of increased uncertainty [23].It has further been argued that the move to an Islamic interest free system, under certain conditions, could lead to increased rates of return on savings. Consequently, the increased level of uncertainty that could result from adoption of PLS based system could be compensated for by an increased rate of return on savings, leaving the overall level of savings unchanged or perhaps even leading to an increase in savings[24].

Muslim economists expect PLS based banking to exercise a favorable effect on the level of investment [25].It has been pointed out that both the demand for investment funds and the supply of investment funds are likely to show an increase consequent on replacement of interest-based banking by PLS based banking. The demand for investment funds is likely to increase as a fixed cost of capital is no longer required to be met as a part of the firm's profit calculations. The marginal product of capital can, therefore, be taken up to the point where maximum profits are obtained without the constraint of meeting a fixed cost of capital. The supply of investment funds is likely to increase as PLS based banking is enabled to undertake the financing of a larger number of risky projects on account of an enhanced risk absorbing capacity[26].

)B) Impact on the Rate and Pattern of Growth

The likely impact of the adoption of Islamic banking practices on the rate and pattern of growth has been discussed by several scholars [27].It has been pointed out that the expected favorable effect of PLS based banking on the level of investment would impart a pronounced growth orientation to the economy. The increased availability of risk capital under the Islamic system would promote technological innovation and experimentation which would be another favourable factor for growth. Islamic banks are also expected to influence the pattern of growth through appropriate selectivity in their financial operations to ensure that the process of growth is broad based and an optimal use is made of bank resources for purposes which rank high in Islamic socioeconomic objectives. It is recognized that the central bank of the country will have to play a strong guiding role in this context.

)C) Impact on Allocative Efficiency

Allocative efficiency of an interest free economy has been an area of major concern in the writings of many Muslim economists [28].It has been stated 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. This position is defended on the basis of the general proposition that any financial development that causes investment alternatives to be compared to one another, strictly based on their productivity and rates of return, is bound to produce allocative improvements, and such a proposition is the cornerstone of the Islamic financial system.

Muslim economists do not deny that investment efficiency requires the use of discounting to take proper care of the time dimension of costs and benefits. They emphasize that non-existence of interest does not mean that discounting as a technique of computing the present value of future cash flows cannot be used in an interest free economy. It has further been pointed out that interest rate is not the proper discount factor under conditions of uncertainty even in interest based economies. Under conditions of uncertainty, the rate of return on equity is the proper discount rate. Since the real world is a world of uncertainty and since no real investment in any economy can be undertaken without facing risks, cash flows of such investment should be discounted not by a riskless interest rate but by the true opportunity cost of venture capital[29].

)D)Consequences for the Stability of the Banking System

It has been argued in the literature on Islamic banking that a switch over from interest based banking to PLS based banking would impart greater stability to the banking system. The argument proceeds on the following lines. 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 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 the values of investment deposits. This minimizes the risk of bank failures and enhances the stability of the banking system[30].

)E)Effects on the Stability of the Economic System

The literature on Islamic banking has taken note of apprehensions expressed in certain circles that replacement of interest by profit/loss sharing may make the whole economic system highly unstable as disturbances originating in one part of the economy will be transmitted to the rest of the economy [31].The general consensus holds such apprehensions to be lacking in substance and suggests, on the contrary, that elimination of interest, coupled with other institutional features of an Islamic economy, will tend to enhance stability. It has been pointed out that interest based debt financing is a major factor in causing economic instability in capitalist economies. It is easy to see, for example, how the interest based system intensifies business recession. As soon as banks find that business concerns are beginning to incur losses, they reduce assistance and call back loans, as a result of which some firms have to close down. This increases unemployment resulting in further reduction in demand, and the infection spreads. Islamic banks, on the other hard, are prepared to share in losses which reduces the severity of business recession and enables the productive enterprises to tide over difficult periods without a shut down. Islamic banking has, therefore, to be regarded as a promoter of stability rather than a conduit of instability[32].

.3THE PRACTICE OF ISLAMIC BANKING

The Islamic banking movement began on a modest scale in the early sixties [33]. The earliest experiments in Islamic banking took place in most cases on individual initiative with governments playing a more or less passive role. The later growth of the Islamic banking movement has been significantly helped by the encouragement provided by the governments of a number of Muslim countries. The establishment of Islamic banks in a number of countries has been facilitated by special enactments and suitable changes in banking legislation. It should be mentioned that changes in banking legislation effected in certain countries to facilitate the working of Islamic banks are not intended to confer any special advantages on these banks vis-a-vis the conventional banks. These measures are in fact designed to remove some of the handicaps from which Islamic banks suffer in conducting their operations in an economy where interest based transactions dominate the scene.

Two different approaches are discernible in regard to the adoption of Islamic banking practices. In a number of countries Islamic banks have been started on private initiative. The governments of these countries have not committed themselves to the abolition of interest, and Islamic banks exist side by side with interest based banks.

Pakistan and Iran are following a different approach aimed at economy wide elimination of interest. In Sudan, where Islamic banks co-existed with interest based banks for a long time, the government has now opted for economy wide Islamization of banking. This section of the paper reviews the trends in the practice of Islamic banking in both the settings. It also takes note of the activities of the Islamic Development Bank, which is an international development financing institution working on *shari'ah* principles, the Islamic banking experiments in some non-Muslim countries, and offer of Islamic banking services by conventional banks in certain Muslim countries.

3.1Practice of Islamic Banking - Individual Entities

There are now over fifty Islamic banking institutions operating in different countries encompassing most of the Muslim world. Two major international holding companies, namely, the Dar al-Mal al-Islami Trust and the Al-Baraka Group control a number of Islamic banks. Most others have been established by associations of individual sponsors. In some banks there is also a certain amount of government participation in the share capital.

Islamic banks conduct their banking operations under *shari'ah* principles. Almost all of them have *Shari'ah* Supervisory Boards as part of their organizational structure. The function of *Shari'ah* Supervisory Board is to ensure the compatibility of all the operations of Islamic banks with the requirements of *shari'ah*.

Islamic banks accept both demand deposits and saving and time deposits. Demand deposits are treated as *qard al-hasanah* .The bank is given permission to use the deposit amounts at its discretion but with guarantee of returning the full principal amount on demand. Saving deposits are differentiated from demand deposits as they are subject to certain restrictions with respect to the amounts that can be withdrawn from such accounts at any one time and the periodicity of such withdrawals. Some Islamic banks accept saving deposits on profit/loss sharing basis while others do not pay any return on these deposits and guarantee the principal amount. Time deposits are accepted by Islamic banks on profit/loss sharing basis and are generally known as "Investment Accounts" or "Investment Deposits". The investment deposits of Islamic banks can have different maturity periods. The return on investment deposits is specified as a percentage of total profits in most cases, but in some cases the percentage return varies with the length of the period for which the deposits are made. Apart from limited period deposits, some Islamic banks also accept unlimited period investment deposits. In this case, the period of deposit is not specified and the deposits are automatically renewed unless a notice of termination of deposits is given of a mutually agreed time interval. Some Islamic banks also have specific investment accounts in which deposits are made for investment in particular projects. The return to depositors in these accounts depends on the outcome of these particular projects and the ratio of profit sharing agreed between the bank and the depositors.

Islamic banks operating in different countries are using a combination of the different financing techniques permissible in *shari'ah* .However, most of them lean heavily on *bai muajjal/murabahah* in their operations. This is for two main reasons. Their orientation mainly is towards short term financing of trade transactions for which *bai muajjal/murabahah* appear to be more convenient devices compared to the system of profit/loss sharing. Secondly, they are in competition with interest based banks and are therefore anxious to earn at least as much on their investments as will enable them to give a return roughly comparable to prevailing interest rates to their investment account holders. This is easier to achieve by engaging in *bai muajjal/murabahah* transactions as the "mark-up" can be fixed in a manner which more or less assures the required return. On the other hand, considerable uncertainty attaches to earnings under a system of profit/loss sharing as the outcome depends on the operating results of various business units which are subject to the usual business hazards.

Excepting the three countries where Islamization of the banking system has taken place on an economy wide basis, Islamic banks in other countries are at a considerable disadvantage in facing the competition with conventional banks as they cannot avail of the facilities of the money market which operates on the basis of interest. This forces them to work with much higher liquidity ratios which has implications for their profitability. Islamic banks also face a number of problems in investing their funds internationally as they cannot take advantage of the facilities of the Eurocurrency market and the Eurobond market which offer ready investment outlets for conventional banks.

Notwithstanding the handicaps from which they suffer, Islamic banks have succeeded in mobilizing large amounts of funds. A detailed study of the working of Islamic banks in different countries conducted in the Islamic Research and Training Institute of the Islamic Development Bank sometime back (called IRTI study hereinafter) showed that deposits in almost all Islamic banks were growing at a rapid pace [34].Two other studies testify to the highly successful deposit mobilization by Islamic banks. According to one [35],the data relating to the period 1980-1986 showed that the relative growth of Islamic banks was better in most cases than the growth of other banks. This relative growth resulted in increasing the shares of Islamic banks in total deposits.

The same study mentions that quite a few Islamic banks had grown to become financial institutions of a respectable size within a relatively short period of time. Kuwait Finance House, Faisal Islamic Bank of Egypt and Massraf Faysal Al-Islami of Bahrain had made such rapid progress that they were counted among the seven largest banks of their respective countries within a short period after their establishment. The other study [36] observes as follows: "These early institutions have now matured, and have achieved a considerable degree of success in terms of market penetration. This is all the more remarkable given that the markets in which they were established already had well developed commercial banks; indeed, some markets, especially in the Gulf, were viewed as overbanked."

Islamic banks have generally a good track record of profitability [37].Like conventional banks, Islamic banks also have had problems in the recovery of their dues during periods of business recession or suffered losses in some investments which did not pay off but these have not grown to any crisis proportions. The *Dar al-Mal al-Islami* ,which is a holding company for a large number of Islamic banks did suffer operating losses in 1983 and 1984, and the Kuwait Finance House had a bad year in 1984 when neither the shareholders nor the depositors received a return on their capital. However, both these institutions recovered from the setback in 1985 and showed good profits. There are of course substantial differences in the performance and profitability of individual institutions within the Islamic banking community but this is not surprising because operating conditions and business environment differ widely from country to country and from time to time in the same country.

Islamic banks are expected to contribute positively towards the achievement of a pattern of growth best suited for the eradication of poverty, equitable distribution of income and wealth and sufficient opportunities for gainful employment. Enough information is not available in regard to operations of Islamic banks in different countries to assess whether they have significantly helped in achieving the Islamic egalitarian objectives. The annual reports of some of the Islamic banks do mention that social considerations are given due importance in planning their operations. The charters of many Islamic banks make specific mention of Islamic socioeconomic objectives being the guiding force of their activities. How far these intentions have actually been translated into practice is difficult to judge in the absence of relevant data. However, there are some indicators which lead to the inference that most of the Islamic banks have not been able to give sufficient attention to financing activities of a developmental nature .From the data given in the IRTI study it appears that most of the finance being provided by the Islamic banks went to the trade sector. In the case of some banks, trade financing constituted up to 90 percent of total financing. Data relating to the term structure of finance in the same study showed that most Islamic banks concentrated on providing short term finance of six months or less or medium term finance of one year or less. These data also corroborate that developmental bias is not prominent in their financing operations. However, time series data which are available for some Islamic banks show that as a bank grows in age and experience, it tends to bring about a shift in the pattern of its financing operations in favor of both longer duration financing and greater attention to the developmental requirements of agriculture and industry [38];and that it expands its client base and pays greater attention to its social responsibilities by extending larger assistance to small scale industries and new employment generating activities[39].

3.2Islamic Banking in Pakistan

The process of economy wide Islamization of the banking system in Pakistan was initiated soon after a declaration by the then President of Pakistan in February 1979 that Government planned to remove interest from the economy within a period of three years and that a decision had been taken to make a beginning in this direction with the elimination of interest from the operations of the House Building Finance Corporation, National Investment Trust and mutual funds of the Investment Corporation of Pakistan. Within a few months of this announcement, these specialized financial institutions took the necessary steps to reorientate their activities on a non-interest basis. The conversion of the operations of commercial banks to non-interest basis was a much more complex task and took a longer time span. To begin with, steps were taken in January 1981 to set up separate counters for accepting deposits on profit/loss sharing basis in all the domestic branches of the five nationalized commercial banks. The parallel system, in which savers had the option to keep their money with the banks either in interest bearing deposits or PLS deposits, continued to operate till the end of June 1985. As from Ist July 1985, no banking company is allowed to accept any interest bearing deposits except foreign currency deposits which continue to earn interest. As from that date, all deposits accepted by a banking company share in the profit and loss of that banking company [40], except deposits in current account on which no interest or profit is given and whose capital sum is guaranteed.

The central bank of the country has issued instructions specifying twelve modes of financing in which funds mobilized by the banks can be employed. These are broadly classified into three groups: (a) loan financing, (b) trade related modes of financing, and (c) investment modes of financing. Loan financing takes the form either of *qard al-*

hasanah given on compassionate grounds free of any interest or service charge (repayable when the borrower is able to repay) or of loans with a service charge not exceeding the proportionate cost of the operation [41].Trade related modes of financing include the following: (i) purchase of goods by banks and their sale to clients at appropriate mark up in price on deferred payment basis, (ii) purchase of trade bills, (iii) purchase of movable or immovable property by the banks from their clients with buy-back agreement or otherwise, (iv) leasing, (v) hire-purchase, and (vi) financing for development of property on the basis of a development charge. Investment modes of financing include the following: (i (*musharakah*) ii) equity participation and purchase of shares (iii) purchase of Participation Term Certificates [42],and *mudarabah* certificates, and (iv) rent sharing.

The central bank of the country has been authorized to fix the minimum annual rate of profit which banks should keep in view while considering proposals for provision of finance, and the maximum rate of profit they may earn. These rates may be changed from time to time. It has also been laid down that should losses occur, they must be shared by all the financiers in proportion to the respective finances provided by them.

A beginning in the direction of introducing the *mudarabah* technique of financing was made in June, 1980 when a law was promulgated under which companies, banks and other financial institutions can register themselves as *mudarabah* companies and mobilize funds through the issuance of *mudarabah* certificates. Funds obtained through a *mudarabah* can only be used in such businesses which are permitted under *shari'ah* ,and need prior clearance from a Religious Board established by the government specifically for the purpose.

To safeguard the banks against delays and defaults in repayment by parties obtaining finance from them, a new law called the Banking Tribunals Ordinance was promulgated in 1984. The tribunals set up under the Ordinance are required to dispose of all cases within ninety days of the filing of the complaint. Appeals against the verdicts of tribunals can be filed in the High Courts within thirty days but the decretal amount has to be deposited with the High Court of appeal. In cases where the decree remains unimplemented beyond a period of thirty days, the tribunals can also impose fines.

Though a number of steps have been taken since 1979 for the elimination of interest from the financial sector in Pakistan, the process of Islamization is yet to run its full course. Nothing has been done so far to eliminate interest from government transactions. To begin with, commercial banks were precluded from investing PLS deposits in interest bearing government securities. With the withdrawal of this restriction in August 1985 the movement towards an interest free economy has suffered a serious retardation. Another disappointing feature of the situation is the lack of any notable progress in the transition to profit/loss sharing on the assets side of the banking system [43].The Islamization process has been marked by another serious deficiency in that no institutional mechanism exists for a continuous scrutiny of the operating procedures of banks and other financial institutions from the *shari'ah* point of view. Individual scholars who have examined these operating procedures have pointed out several areas where the actual banking practices show deviation from *shari'ah* .Recently the Federal Shariat Court in one of its judgements has held that the system of mark-up financing as being actually practiced by banks is not in conformity with the injunctions of Islam [44].The mandatory targets that are set every year for bank financing of small business, small scale industry and small farmers are in line with Islam's egalitarian objectives. In the recent past some additional steps have been taken to reduce the concentration of bank finance among big business groups [45]and to expand the availability of bank finance to low income groups [46]but a really strong drive to use the banking system for achieving Islamic socioeconomic objectives is yet to be undertaken.

3.3Islamic Banking in Iran

A new banking law was enacted in Iran in August 1983 to replace interest based banking by interest free banking. The law required the banks to convert their deposits to an interest free basis within one year, and their other operations within three years, from the date of the passage of the law, and specified the types of transactions that must constitute the basis for asset and liability acquisition by banks. The law also specified the responsibilities of the central bank under the new system and the mechanics of its control over the banking system.

The law allows the banks to accept two types of deposits, viz ,.*qard al-hasanah* deposits and term investment deposits. The *qard al-hasanah* deposits comprise of current as well as savings accounts which differ in their operational rules. The holders of current and savings accounts are guaranteed the safety of their principal amounts and are not entitled to any contractual return. However, banks are permitted to provide incentives to depositors through (i) grant of prizes in cash or kind, (ii) reduction in or exemption from service charges or agent's fees payable to banks, and (iii) according priority in the use of banking facilities. Holders of term investment deposits are entitled to receive a variable return, depending on the profitability of the projects in which these funds are invested. The law allows the banks to undertake and/or ensure the repayment of the principal amounts of term investment deposits.

The law provides various modes of operation upon which the financing transactions of banks must be based. Banks are obliged to earmark a portion of their resources for grant of *qard al-hasanah* to help achieve the socioeconomic objectives set out in the constitution of the country [47].Besides *qard al-hasanah* ,banks are authorized to extend financial assistance for productive ventures on profit/loss sharing basis in accordance with the principles of *mudarabah* and *musharakah* .Banks are allowed to provide part of the capital of a new joint stock company and also to purchase shares of existing joint stock companies. Banks are authorized to provide working capital financing to productive units by purchasing raw materials, spare parts and other items on their request for sale to them on the basis of deferred payment in installments. Purchase of machinery and equipment for sale to their clients on deferred payment basis is also allowed. Another mode is called *salaf* which is the same as *bai salam* and is used for meeting working capital requirements through advance purchase of output. Banks can engage in lease-purchase transactions. They can also provide finance on the basis of *jo'aalah*) commission for working as agent ,(*mozara'ah*) financing of agricultural production on profit sharing basis ,*mosa'qaat*) financing of orchard production on profit sharing basis). In addition to these modes of financing, banks are permitted to purchase debt instruments of less than one year maturity if these debts are issued against real assets[48].

In the new set up, the central bank of the country has been given wide authority to control and supervise the operations of the country's banks. While it continues to have many of the erstwhile credit control weapons which do not involve *riba* ,it has been endowed with new instruments of control to regulate the interest free operations of banks. These include power to determine (a) minimum and maximum expected rates of return from various facilities to the banks (b) minimum and maximum profit shares for banks in their *mudarabah* and *musharakah* activities, and (c) maximum rates of commission the banks can charge for investment accounts for which they serve as trustees.

Studies on the progress made in the implementation of the new system show that banks have, in general, adapted well to new procedures. Problems have been encountered, however, in moving away from traditional short term trade financing operations and toward profit sharing medium and long term financing operations. It was expected that with the passage of time banks would increase their involvement in *mudarabah* and *musharakah* financing but this expectation has not been fulfilled. Comparative data for the period 1984-85 to 1989-90 show that the share of *mudarabah* in total bank financing has actually gone down from 18.1 percent to 10.7 percent [49].The combined share of "civil partnership" and "legal partnership" has remained almost unchanged at 18 percent over this period .[50]The share of "installment sales", on the other hand, has gone up from 33.3 percent to 46.4 percent during the same period[51].

Studies on the Islamic banking experience of Iran have pointed out that no attempt has been made so far to Islamize the international banking and financial operations [52].Government continues to borrow from banks on the basis of a fixed rate of return [53].It has also been pointed out that some banking practices in Iran are at variance with the practice of Islamic banking in other countries[54].

A number of studies refer to the conscious efforts made in recent years to reorientate the activities of banks in Iran to achieve Islamic socioeconomic objectives [55]. The banking system has been used as an instrument of restructuring the economy, away from services and consumption toward production. Bank financing to the services sector has been drastically curtailed. Banks have reduced financing for the production of luxury goods and commodities with a large import content, while financial assistance for the production of necessities and intermediate goods has been appreciably increased. Financing facilities for the agricultural sector have been considerably expanded. The banking system has also been used as an instrument of income redistribution through the provision of *qard al-hasanah* loans to low income groups, financing the building of low cost houses, and provision of financing for small scale agro-business and industrial cooperatives often without stringent collateral requirements.

3.4Islamic Banking in Sudan

The process of the economy wide Islamization of the banking system in Sudan has not been smooth and steady. The first attempt to Islamize the entire banking system was made in 1984 when a presidential decree was issued directing all commercial banks to stop interest based dealings with immediate effect and to negotiate the conversion of their then existing interest bearing deposits and advances into Islamically acceptable forms. Foreign transactions were allowed to be continued on the basis of interest for the time being. It is reported that this sudden change forced the banks to adopt the nearest Islamic alternative available that is ,*murabahah* ,which soon constituted 90 percent of their financial operations .[56]It is also reported that "conventional banks applied Islamic financing techniques only formally in their ledger books and in the reports submitted to the central bank of the country. Policy makers in the central bank were also discontented with the procedure of transforming the banking system. They considered it as a mere political decision imposed by the government without being preceded by adequate detailed studies [57]."This experiment with economy wide Islamization of banking system came to an end in 1985 with the change in government .The government which is presently in power has decided on the economy wide Islamization of the banking system once again, and newspaper reports indicate that the effort is much more earnest and much better organized this time.

3.5Islamic Development Bank

The Islamic Development Bank, established in 1975, is an international financial institution whose purpose is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *shari'ah* .It has 47 members and a subscribed capital of 2,028.74 million Islamic dinars [58].The functions of the Bank are to participate in the equity capital and grant loans for productive projects in member countries and to provide financial assistance in other forms for economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries. The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods, among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *shari'ah*.

Following the continuous growth of the Bank financing operations to support efforts for economic development in member countries, the Bank has sought to mobilize additional resources. An Investment Deposit Scheme was initiated in 1980 under which deposits are accepted from institutions and individuals for use in foreign trade financing operations. An Islamic Banks' Portfolio was created in 1987 which aims at mobilizing liquid funds of Islamic banks and financial institutions. The IDB Unit Investment Fund was launched in 1989 to generate additional financial resources for the Bank and to invest them on a basis compatible with the *shari'ah*.

The cumulative financing approved by the Bank since its inception till the end of 1991-92 amounted to 9389.13 million Islamic dinar. Foreign trade financing, based on *murabahah* ,has accounted for the bulk of the total resources provided by the Bank to its members. It accounted for 72.5 percent of total financing. Loans provided on the basis of a service charge accounted for 8.2 percent while leasing and installment sales accounted for 5.3 percent and 6.3 percent of total financing respectively. Equity participation accounted for 2.2 percent of total financing while the assistance provided through profit sharing accounted for 0.2 percent of total financing.

Equity participation and profit sharing are regarded as the chief distinguishing features of Islamic banking and finance. It is disappointing to note, therefore, that they have so far played a very minor role in the financing operations of the Islamic Development Bank. A detailed study of the working of the Bank by one of its former principal officers points out that it "started its equity financing operations enthusiastically and gradually built up this activity to its highest level in the year 1401H. However, since then the operations have dropped sharply in view of the Bank's unhappy experience with several of its equity investments [59]."The same study also analyses the reasons for this unhappy experience .The over-anxiety of the Bank in its initial years to expand the network of equity financing to cover as many of its member countries as possible, lack of sufficient professional expertise in the Bank to undertake an adequate appraisal of projects and to pursue the task of vigorous follow up of its equity investments, delay in the implementation of projects financed by the Bank, marketing difficulties and currency devaluation have been cited as the main factors responsible for this situation [60].It is reported that the Bank is engaged in devising corrective measures and safeguards and equipping itself better for undertaking equity financing by directing greater attention to macro-economic conditions and policies affecting its projects, stricter supervision and linking disbursements to project implementation[61].

3.6Islamic Banking in Non-Muslim Countries and Offer of Islamic Banking Services by Conventional Banks in Muslim Countries

Some interesting experiments have been made of what may well be called institutionalized use of Islamic modes of deposit mobilization and financing, if not full-fledged Islamic banking, in quite a few non-Muslim countries. Thus Islamic financial institutions exist in countries so far apart as Australia, Denmark, India, Liberia, Liechtenstein, Luxembourg, Philippines, South Africa, Thailand, United Kingdom and the United States of America. Apart from these, there are a number of non-Islamic financial institutions in non-Muslim countries which offer Islamic financial services for their Muslim clients [62].There is a good deal of controversy, however, about the financial services being offered by such institutions being in full conformity with *shari'ah* requirements[63].

The demand for Islamic banking services is so strong and persistent among the Muslim masses that authorities in certain Muslim countries have given permission to conventional banks to open "Islamic banking windows". This has been the case in Egypt for quite sometime. Recently such permission has also been accorded in Saudi Arabia and Malaysia.

.4CONCLUSION

The theory and practice of Islamic banking are attracting world wide attention at the present moment. Establishment of a new pattern of banking which is radically different from the conventional one is a formidable task, and the degrees of freedom in fashioning the new system are also limited because all the techniques have to conform to *shari'ah* .The theoretical literature on Islamic banking that has become available in recent years has shown the way in which a truly distinctive form of banking, which is fully in line with the ethos of the value system of Islam, may be established. The theoretical literature has also taken note of the various misgivings and sought to examine them in an objective manner .The likely socioeconomic consequences of adopting the Islamic system of banking and finance have also been thoughtfully analyzed. Along with the theoretical developments, the practice of Islamic banking has been growing rapidly, and there have been a number of contributions shedding light both on the operating procedures of Islamic banks as well as the results achieved in terms of deposit mobilization, profitability and achievement of Islamic socioeconomic objectives. All this is a good beginning. There is no doubt that as time passes, research will proceed to further investigate the theoretical and empirical aspects of Islamic banking. The following lines indicate some areas of research and study which appear to deserve priority in the context of the present stage of development of the Islamic banking movement.

4.1Theoretical Issues

i)Examination of the permissibility of credit creation by banks from the *shari'ah* point of view.

ii)Seigniorage (i.e., profits of money creation, its entitlement and distribution.(

iii)Risk and expectational characteristics of households, firms and banks in an interest free economy.

iv)Ways of introducing negotiable papers in the Islamic financial market.

v)Ways of controlling "hot money" movements in an Islamic framework of money and banking.

4.2Operational Issues Relating to the Practice of Islamic Banking

i)Shall the banks remain financial intermediaries or enter directly in trade and industry?

ii)Identification of reasons, both general and country specific, which have stood in the way of greater use of profit/loss sharing techniques in Islamic banks' financing operations.

iii)Ways and means of promoting greater use of profit/loss sharing techniques in Islamic banks' financing operations.

iv)What concrete steps can be taken to better attune the Islamic banks for playing a more dynamic role in the attainment of Islamic socioeconomic objectives?

v)Issues relating to accounting: Determination of profit and loss in profit/loss sharing arrangements, and treatment of costs and reserves in such accounting.

4.3 Issues Related to World Wide Strengthening of the Islamic Banking Movement

i)Problems and prospects of wider diffusion of Islamic banking in the Muslim world.

ii)Problems of Islamic banking in non-Muslim countries and ways of resolving these problems.

iii)Role of the Islamic Development Bank in strengthening the Islamic banking movement.

iv)Role of Islamic banks, the media and other institutions in projecting a correct image of Islamic banking.

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.24Nadeem Ul Haque and Abbas Mirakhor, "Optimal Profit-Sharing Contracts and Investment in an Interest Free Islamic Economy ,"*op.cit*.

.25For some important contributions on the subject, see the study by Nadeem Ul Haque and Abbas Mirakhor mentioned in the preceding note as also M. Umer Chapra , *Towards a Just Monetary System* ,*op.cit* ,.pp. 111-117; and M. Nejatullah Siddiqi ,*Issues in Islamic Banking* ,*op.cit* ,.pp.88-89.

.26The risk absorbing capacity of banks is enhanced in the PLS based system as the nominal value of investment deposits is not guaranteed and banks are not bound to pay a pre-determined return on such deposits.

.27See, for instance, M. Umer Chapra ,*Towards a Just Monetary System ,op.cit* ,.pp. 122-125, and Abul Hasan M. Sadeq, "Economic Growth in an Islamic Economy" in Abul Hasan M. Sadeq *et al*) eds.) (1991 ,(*Development and Finance in Islam* , pp.55-71.

.28See, especially, M. Anas Zarqa (1982" ,(Capital Allocation, Efficiency and Growth in an Interest Free Islamic Economy" in *Journal of Economics and Administration* , Jeddah, K.A.U., pp.43-55.

.29For an elaboration of this theme, see M. Anas Zarqa, "An Islamic Perspective on the Economics of Discounting in Project Evaluation" in Ziauddin Ahmad *et al*) eds.) (1983 ,(*Fiscal Policy and Resource Allocation in Islam* ,Islamabad : Institute of Policy Studies, pp.203-234.

.30For a lucid exposition of this proposition, see Mohsin S. Khan, "Islamic Interest Free Banking: A Theoretical Analysis" in Mohsin S. Khan and Abbas Mirakhor (eds ,(.*Theoretical Studies in Islamic Banking and Finance ,op.cit* ,.pp.15-35.

.31For an expression of this, see S. N. H. Naqvi (1981 ,(*Ethics and Economics: An Islamic Synthesis* ,Leicester, U.K. : The Islamic Foundation, p.136.

.32See, M. Anas Zarqa, "Stability in an Interest-Free Islamic Economy: A Note" in the *Pakistan Journal of Applied Economics* ,Winter 1983, pp.181-88.

.33The Myt Gamt Saving Bank ,established in 1963 in a provincial rural center in the Nile delta of Egypt, is considered to be the first Islamic bank in modern times. The bank's operations, which were based on the *shari'ah* ,covered five areas: deposit accounts, loan accounts, equity participation, direct investment, and social services. Though the experiment was localized, the nine branches opened by the bank attracted a very large number of clients and generated a great deal of popular enthusiasm.

.34Ausaf Ahmad (1987 ,(*Development and Problems of Islamic Banks* ,Jeddah: IRTI.

.35Volker Nienhaus (1988), "The Performance of Islamic Banks: Trends and Cases" in Chibli Mallat ,*Islamic Law and Finance* ,London : Center of Near and Middle Eastern Studies, University of London, pp.83-122.

.36See, Rodney Wilson (ed.) (1990 ,(*Islamic Financial Markets* ,London : Routledge, p.7.

.37For data on profitability of Islamic Banks, see Ausaf Ahmad ,*Development and Problems of Islamic Banks ,op.cit* ,.pp. 51-62; and Volker Nienhaus, "The Performance of Islamic Banks: Trends and Cases" in Chibli Mallat ,*Islamic Law and Finance ,op.cit* ,.pp. 95-108.

.38See, Albagkir Y. Mudawi (1986), "Islamic Medium and Long Term Finance ," *Arabia*) ,August.(

.39See Osman Ahmed, "Sudan: The Role of the Faisal Islamic Bank" in Rodney Wilson (ed (.*Islamic Financial Markets ,op.cit* ,.pp.92-97.

.40The rates of profit are worked out by a formula that determines net profit accruing to a bank and allocates to remunerable liabilities according to their maturities. Allocations are based on differential weights assigned to liabilities according to relative maturities.

.41The central bank of the country has laid down that the maximum rate of service charge which a bank may recover on such loans during an accounting year is to be calculated by dividing the total of its expenses, excluding cost of funds and provision relating to bad assets and income taxation, by the mean of its total assets at the beginning and the end of the year and rounding off the result to the nearest decimal for a percentage point.

.42Participation Term Certificates are negotiable instruments designed to replace debentures for meeting medium and long term financing requirements of business concerns. Instead of receiving interest, as in the case of debentures, the holders of these certificates share in the profit or loss of concerns raising finance through this device. For more details, see Ziauddin Ahmad, "The Present State of Islamic Finance Movement", paper presented at a conference on Islamic Banking in New York (Islamabad, International Institute of Islamic Economics, 1985.(

.43The central bank of the country has not yet started publishing data on a regular basis on the shifts in banks' assets structure and use being made of various modes of financing. The last published data on this subject relate to December, 1984. These show that equity participation and *musharakah* financing accounted for only 10 percent and 4 percent respectively of total financing. For details, see Zubair Iqbal and Abbas Mirakhor, (1987 ,(*Islamic Banking ,op.cit* ,.p.20.

.44Some appeals have been filed against the decree of the Federal Shariat Court and the case is pending before the Shariat Appellate Bench of the Supreme Court of Pakistan.

.45A set of Prudential Regulations for banks were issued by the central bank of the country in 1992 which aim, among other things, to limit bank financing to any single person and to link a firm's access to bank finance to the firm's equity.

.46A scheme for expanding the availability of bank finance for unemployed persons to enable them to own transport vehicles for hire was initiated in 1992.

.47The law stipulates that rules and regulations relating to grant of *qard al-hasanah* will be drawn up by the central bank of the country and approved by the Council of Ministers.

.48For more details about the various modes of financing in use in Iran, see Zubair Iqbal and Abbas Mirakhor ,*Islamic Banking* ,*op.cit* ,.pp. 10-11.

.49See S. A. A. Hedayati" ,Some Theoretical and Philosophical Aspects of Islamic Banking : A Dimension of Islamic Economics", paper presented at a course in Islamic banking (1992), p.43.

.50 *Ibid*.

.51 *Ibid*.

.52S.H. Amin (1989 ,(*Islamic Law and Its Implications for the Modern World* ,Glasgow: Royston Ltd. p.135.

.53In one of the studies it is stated: "In the case of the Islamic Republic of Iran, it has been decreed that financial transactions between and among the elements of the public sector, including Bank Markazi and commercial banks that are wholly nationalized, can take place on the basis of a fixed rate of return; such a fixed rate in not viewed as interest. Therefore, the government can borrow from the nationalized banking system without violating the injunction of the Law". See Zubair Iqbal and Abbas Mirakhor ,*Islamic Banking* ,*op.cit* ,.p.24.

.54A case in point is the treatment of investment deposits. In Iran, the law allows the nominal value of such deposits to be guaranteed while such a guarantee is not considered compatible with Islamic teachings in other countries.

.55See Abbas Mirakhor, "The Progress of Islamic Banking: The Case of Iran and Pakistan" in Chibli Mallat ,*Islamic Law and Finance* ,*op.cit* ,.p.55; and Mohsin S. Khan, "The Theory and Practice of Islamic Banking", paper presented at a course in Islamic Banking (1992), p.21.

.56This is reported in a paper presented in Arabic at a conference in Tunis in 1985 which finds a mention in M. Nejatullah Siddiqi" ,*Islamic Banking: Theory and Practice* ,"*op.cit* ,.p. 49.

.57Osman Ahmed, "Sudan: The Role of the Faisal Islamic Bank" in Rodney Wilson (ed ,(.*Islamic Financial Markets* ,*op.cit* ,.p. 77.

.58One Islamic Dinar is equal to one Special Drawing Right (SDR) of the International Monetary Fund.

.59S. A. Meenai (1989 ,(*The Islamic Development Bank: A Case Study of Islamic Cooperation* ,London : Kegan Paul, p.74.

.60 *Ibid* ,pp.74-77.

.61 *Ibid* ,pp. 199-200.

.62Among these are such well-known institutions as Kleinworth Benson which offers an Islamic Unit Trust, and the Union Bank of Switzerland and Landerbank of Vienna which offer Islamic investment funds.

.63 See Rodney Wilson (ed ,(.*Islamic Financial Markets* ,*op.cit* ,.p.29.

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