INTERNSHIP REPORT

ON

"Islami Banking and Ideology"

SUPERVISED BY
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Assistant Professor
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SUBMITTED BY
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This internship report is submitted to the faculty of Business Studies, Hajee Mohammad Danesh Science and Technology University, Dinajpur, in partial fulfillment of the requirements for the degree of M.B.A. (Evening) program.

Faculty of Business Studies

HAJEE MOHAMMAD DANESH SCIENCE AND TECHNOLOGY UNIVERSITY, DINAJPUR-5200

OCTOBER, 2016

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Master of Business Administration (Evening)

Faculty of Business Studies

HAJEE MOHAMMAD DANESH SCIENCE AND TECHNOLOGY UNIVERSITY, DINAJPUR-5200

OCTOBER, 2016

DEDICATED TO
MY
RESPECTABLE
PARENTS
AND
HONOURABLE
TEACHERS

Letter of Transmittal

24 October, 2016

Rony Kumar Datta

Assistant Professor

Department of Finance and Banking

Faculty of Business Studies

HSTU, Dinajpur

Subject: Submission of Internship Report of MBA (Evening) Program.

Dear Sir,

It is my great pleasure to submit the internship report on **"Islami Banking and Ideology"** which is a part of MBA (Evening) Program to you for your kind consideration.

I made sincere efforts to study related materials, documents, observe operations performed in IBBL and examine relevant records for preparation of the report.

Within the time limit, I have tried my best to compile the pertinent information as comprehensively as possible.

Thanking you,

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Md. Rezaul Kabir
Student ID- E-140504059
M.B.A. (Evening), 4^{th} Batch
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Student's Declaration

The discussing report is the terminal formalities of the internship program for the degree of Master of Business Administration (Evening), Faculty of Business Studies at Hajee Mohammad Danesh Science and Technology University, Dinajpur which is compact professional progress rather than specialized. This report has prepared as per academic requirement after successfully completing the 45 days internship Program under the supervision of my honorable supervisor

Rony Kumar Datta, Assistant Professor, Department of Fiancé and Banking. It is my pleasure and great privilege to submit my report titled **"Islami Banking and Ideology"**, as the presenter of this report; I have tried my level best to get together as much information as possible to enrich the report. I believe that it was a fascinating experience and it has enriched both my knowledge and experience.

I believe everyone is not beyond of limitation. There might have problems regarding lack and limitation in some aspects and also some minor mistake such as syntax error or typing mistake or lack of information. Please pardon me for that mistake and clarify these of my further information on those matters.

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Md. Rezaul Kabir
Student ID- E-140504059
M.B.A. (Evening), 4th Batch
Major in Finance
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Declaration of Supervisor

It's my Pleasure to Certify that Md. Rezaul Kabir, Student ID: E-140504059, MBA (Evening) Major in Finance, 4th Batch has successfully completed MBA (Evening), Internship report titled **"Islami Banking and Ideology"** under my supervision and guidance.

Therefore, he is directed to submit his report for evaluation. I wish his success at every sphere of his life.

Rony Kumar Datta
Assistant Professor and
Supervisor
Department of Finance and Banking
HSTU, Dinajpur

Declaration of Co-Supervisor

It's my Pleasure to Certify that Md. Rezaul Kabir, Student ID: E-140504059, MBA (Evening) Major in Finance, 4th Batch has successfully completed MBA (Evening), Internship report titled **"Islami Banking and Ideology"** under my supervision and guidance.

Therefore, he is directed to submit his report for evaluation. I wish his success at every sphere of his life.

____

Rafia Akhtar
Associate Professor and
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Acknowledgement

At first I would like to thank my honorable supervisor of internship program, **Rony Kumar Datta**, Assistant Professor, Department of Finance and Banking, and co-supervisor **Rafia Akhtar**, Associate Professor, Department of Management, HSTU, Dinajpur for providing me such an opportunity to prepare an Internship Report on **"Islami Banking and Ideology"**. Without his helpful guidance, the completion of this project was unthinkable.

During my preparation of the project work I have come to very supportive touch of different individuals & friends who lend their ideas, time & caring guidance to amplify the report's contents. I want to convey my heartiest gratitude to them for their valuable responses.

October, 2016 ***The Author***

Excuative Summary

Banking sector is considered as the barometer of national economy. The first Islami Bank was established in 1983 with a view to develop economic and social programs of Bangladesh by rein foreign investment, assisting in financing and promoting economic and social welfare of Muslim community has launched several programs in banking based on Islami Sharia.

The business performance of Islami Banking with respect to its commitment, cumulative commitment, loan disbursement and implementation of projects lease financing, investors account and recovery and rehabilitation activities have been analyzed. In the report, the financial performance of different Islami Bank are analyzed through discussing total income, total expense, net profit, dividend appropriation of total profit, grand total profit etc.

The findings of this report is that Islami Banking has been growing faster and better the average of the banking sector in terms of deposits, loans and advances and expansion. Islami Banking is pioneer of Islami Shariah banking in Bangladesh. The bank's growth rate in terms of deposits, as well as loans and advances are better than the average rates of private banks.

Moreover, market share of Islami Banking in the private banking sector in terms of deposit and loans and advances are increasing day by day. Another important factor is that the earnings of Islami Banking in relation to equity, loans and advances, and assets are more than the average ratios of private banks, especially when the bank is compared with the 57 banks established before 2002. Islami Banking activities are vast and elaborated but my study is concentrated mainly in the Islami Banking and Ideology.

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CHAPTER ONE

INTRODUCTION

1.1 Introduction:

Banks are financial institutions engaged in boosting national savings and capital formation as well as constituting infrastructure through the financing of various development projects. It performs multi-dimensional activities like borrowing and lending of money, drawing, collecting and discounting bills, transferring funds, safe deposit, vault/locker service, foreign exchange transactions etc. The world of banking is undergoing a transformation. Banking today has evolved into a highly competitive and sophisticated business in which technology increasingly provides the edge. Today's customers want service and information to be provided at all times and places.

As Bangladesh is one of the largest Muslim countries in the world, the deep commitment of the people of this country to the Islamic way of life according to the Holy Quran and the Sunnah. Obviously, it remains a deep cry in their hearts to fashion and design their economic lives in accordance with the precepts of Islam. The establishment of first Islami Bank on March 13, 1983, is the exact reflection of this inner urge of its people. Islami Banking are devoted to conducting all banking activities on the basis of interest free & profit and loss sharing system.

1.2 Origin of the Study:

The current world is changing rapidly. To face the challenge of competitive free market economy, to keep pace with the trend of every organization who demanded executive with modern knowledge and to provide fresh graduate with modern theoretical and professional knowledge in banking as well as all other different institutions, Hajee Mohammad Danesh Science & Technology University, Thakurgaon has assigned the internship program for the students to help them out to have a practical knowledge to work in a real office environment. Under this program the students are sent to gather practical knowledge about the working environment and activities. The report is a requirement of the internship program for my MBA (Evening) degree. It is suggested by the supervisor Rony Kumar Datta, Assistant Professor, Department of Finance in Banking that the topic of the report would be “Islami Bank and Ideology”.

1.3 Rationale of the Study:

There are three types of scheduled commercial banks are in operation in our economy. They are Nationalized Commercial Banks, Private Commercial Banks and Foreign Private Commercial Banks. Islamic Banks have discovered a new horizon in the field of banking area, which offers different general banking, investments and foreign exchange banking services. I have chosen Islami Banking, which has some special mission & vision to establish an interest free banking in the country. From the very beginning since inception the bank has been facing different kinds of problem due to lack of Islamic Banking Act and Islamic Money Market besides general people has no idea about the Islamic mode of operations. So, for obvious reason I have selected the topic.

“Islami Bank and Ideology”. The dissertation report is an integral part of the MBA (Evening) program of the university. So it is obligatory to undertake such task by the students who desire to complete and successfully end-up their MBA (Evening) degree. This also provides an opportunity to the students to minimize the gap between theoretical and practical knowledge. Students are required to work on a specific topic based on their theoretical and practical knowledge acquired during the period of the internship program and then submit it to the respective authority.

1.4 Scope of the Study:

The scope of the organizational part covers the organizational structure, background, products and services and the financial performance of Islami Bank Bangladesh Limited as a whole and the main part covers investment Islami Bank and Ideology. This report helps us to understand the clear real-time experience about the Islami Bank and Ideology. It also helps us to understand how they deal with the islami banking activities clients alongside the way of Islami Bank and Ideology.

This report is only done for gathering information about Islami Bank and Ideology by focusing on the performance and management of Islamic banking business alongside while ignoring any other department of the bank.

1.5 Objectives of the Study:

1.5.1 Broad Objective:

The prime objective of this report is to analyze the “Islami Bank and Ideology”.

1.5.2 Specific Objectives:

In order to accomplish the broad objective following specific objectives are emerged,

- To depict the procedures of Islami Banking follow for lending to the customer.
- To know the evolution of Islamic banking.
- To know the Investment Decisions and Banking Efficiency.
- To evaluate the operational techniques of Islamic Bank
- To compare and analyze the welfare service of Islami Banking with other Islami Banks of Bangladesh as well as the banking sector.
- To recommend actions that may be necessary to redesign the Islami banking management.
- To know the banker customer relationship specially of Islami banking .

1.6 Methodology:

In order to conduct such a study the report preparer must follow some specific methods. This report is based on an empirical method which is stated under.

Trend analysis, ratio analysis and comparative analysis were used to describe the “Islami Bank and Ideology” in this report. So, the report will be descriptive in nature which is possible through descriptive research. As Islami Banking is a part of Bangladesh economy sector, I have nothing to do with the variables other than stating what is doing for managing of Banking and Ideology. According to the base of objective, this research is called descriptive research.

1.6.1 Sources of Data:

All the relevant data regarding this report are collected from two sources,

1.6.1.1 Primary Sources of Data:

I discussed with the officials and executives of the IBBL, Thakurgaon Branch and found the approximate data which has been used and presented in this report. The study has been conducted through the assistance of Banking and Ideology, Thakurgaon Branch as per their operating and maintaining an investment and general banking business through applying modern and technological means. As an officer of IBBL Thakurgaon Branch, I have also physically observed the effectiveness of the efforts relating Islami Banking business effectively and efficiently managed by Islami Bank Bangladesh Limited, Thakurgaon Branch.

Primary sources of data include the following:

- Practical work experience,
- Informal face to face conversation with the clients and officers of the bank.

1.6.1.2 Secondary Sources of Data:

I have collected secondary data from the following sources,

- Annual Reports of IBBL: 2011-2015.
- Business Development Conference Report: 2014 and 2015.
- Unpublished data from the IBBL, Thakurgaon Branch.
- Manuals of IBBL regarding banking business.
- Annual Reports of AIBL, SIBL, EXIMBBL, FSIBL, SJIBL, ICBIBL 2015
- Bank Website of AIBL, SIBL, EXIMBBL, FSIBL, SJIBL, ICBIBL
- Synopsis and training materials provided by the Islami Bank Training and Research Institute.

1.6.2 Data Analysis and Reporting:

Both qualitative and quantitative analyses have been done while conducting this study. Microsoft Word and Microsoft Excel were used to analyze, process and graphically represents the gathered data.

1.7 Limitations of the Study:

Although I have obtained the whole hearted co-operation from the employees of Islarni Bank Bangladesh Limited, Thakurgaon Branch and Islami Bank Training and Research Academy hut in the way of my study, I have faced the following problems, which may be termed as the limitations of the study. Some limitations are as under:

- All the branches of the bank were not physically visited and all the concerned personnel of the bank have not been interviewed.
- Lack of in-depth knowledge and analytical ability for writing such report.
- Learning all the banking functions about the Islami Banking Ideology within just 60 days was really tough.
- Data and information used in this study are mostly from secondary sources.
- Large scale research was not possible due to the constraints and restrictions posed by the bank.

The report has encountered these limitations that may hinder the progress of the study but with constant effort, it has tried to minimize the negative effects of these limitations.

CHAPTER TWO

EVOLUTION OF ISLAMIC BANKING

2.1 Emergence of Islamic Banking

For an expanding economy, a developed and efficient banking system is indispensable. Among others, it helps transfer of financial resources from surplus units to deficit units and, hence, helps accelerate the pace of development by securing uninterrupted supply of financial resources to people engaged in numerous economic activities. The tremendous development that the world economy has experienced in the last few decades was contributed by several factors among which, growing institutional supply of loan able funds must have played the pivotal role. The role of banking is comparable to what an artery system does in the human body. Both commercial banks and other development financial institutions provide short-, medium-, and long-term credits to businesspersons and entrepreneurs who usually take the lead in ventures of economic development.

Institutional supply of credit has been made possible by a system of financial inter-mediation organized in a way where conventional banks collect small savings from the public by offering them a fixed rate of interest and advancing the loan able funds out of the deposited money to enterprising clients charging relatively higher rates of interest. The margin between these two rates is the bank's income. In addition, banks also provide many other services to the public for which it receives service charges

Despite the outstanding contribution of the conventional banking system (interest-based), several ancient and modern economists are critical about its efficiency level. Some economists consider the role of interest in the conventional banking mechanism as a major negative factor that contributes to cyclical fluctuations in the economy (Minsky 1982). Specifically, the ineffectiveness of interest rate as a stabilization tool during the period of the Great Depression is a case to note. This eventually called for Keynesian prescription of government intervention (Keynes 1964). Similar concern was expressed in a story published in Newsweek regarding Henry Kissinger, the former Secretary of State of USA. To quote, “The instability has persisted and the uncertainty has continued. After going through the throes of painfully high levels of inflation, the world economy has experienced a deep recession and unprecedented rate of unemployment, complicated further by high level of real interest rates and unhealthy exchange rate fluctuations” (Newsweek 1983). More recent concern over the potential instability of the world monetary and financial system was expressed by Maurice Allais, a Nobel Laureate, who called for an urgent reform of the World Economic Order (Allais 1993, pp.13-16). Others vehemently oppose the argument for using rate of interest as a stabilizing tool in the economy (Saud 1980, p.88). This called for the emergence of a new system of banking capable of tackling new challenges that the present world economy, particularly the financial sector, has been facing.

In response, though not exactly to that exigency but for quite a few other reasons, the second half of the twentieth century witnessed a distinctly separate line of thinking on banking. This was institutionalized at the end of third quarter and subsequently emerged as a new system of banking called Islamic Banking {also called Profit-Loss-Sharing Banking (PLS)}. The world has now been experiencing operation of as many as 250 Islamic banks and financial institutions in more than 50 countries, Muslim and non-Muslim.

There are religious as well as economic reasons, which have contributed to the emergence of PLS-banking as an alternative to its conventional counterpart. It is the prohibition of 'Riba' in the Quran that, according to the proponents of the PLS-system, was the source of inspiration for establishing banks in line with Islamic Shariah (Muslehuddin 1987, pp.24-27). The basic intention behind establishing Islamic banks was the desire of Muslims to reorganize their financial activities in a way that do not contradict the principles of Shariah and enable them to conduct their financial transactions without indulging into Riba (Ahmad 1992). These writers consider rate of interest in the conventional banking mechanism synonymous to Riba, the term as used in the Quran [2:275; 30:39]. One of the reasons for this is that the outcome of the productive effort is uncertain, and so interest necessarily involves an element of Gharar, that is, uncertainty (Chapra 1985, p.64). On this religious ground, proponents of the PLS-system urge the Islamic community to avoid all transactions with institutions that are interest-based.

The economic reason derived from a verse of the Quran providing inspiration to devise an interest-free financial system has been substantiated in the way that interest, instead of increasing wealth, reduces it [30:34]. The primary reason of why the Quran has taken such a hard approach towards interest is that Islam stands for establishing a just economic system free from all kinds of exploitation (Chapra 1985). Further, Muslim economists consider depression and stagflation very often found in the capitalist world as an outcome of the financial system based on interest (Rahman 1976).

Thus, Islamic banking emerged as a response to both religious and economic exigencies. While religious exigency calls for avoiding any transaction based on interest, economic exigencies, on the other hand, provide a new outlook to the role of banking in promoting investment / productive activities, influencing distribution of income and adding stability to the economy. Islamic banking is thus perceived as an improved system in all dimensions.

2.2 The first attempt

Interestingly, the concept of Islamic Banking is several decades old. The first attempt to establish an Islamic financial institution took place in Pakistan in the late 1950s with the establishment of a local Islamic bank in a rural area (Wilson 1983). Some pious landlords who deposited funds at no interest, and then loaned to small landowners for agricultural development initiated the experiment. The borrower did not pay interest on the credit advanced, but a small charge was levied to cover the bank's operational expenses. The charge was far lower than the rate of interest. Although the experience was encouraging, two main factors were responsible for its failure. First, the depositors' landlords regarded the deposits as a one-time event. With the increasing number of borrowers the gap between available capital and credit demanded was huge. Secondly, the bank staff did not have complete autonomy over its operation; depositors showed considerable interest in the way their money was lent out (Ibid).

2.3 The second attempt

The second pioneering experiment of putting the principles of Islamic banking and finance into practice was conducted in Egypt from 1963 to 1967 through the establishment of the Mit Ghamr Savings Bank in a rural area of the Nile Delta. The experiment combined the idea of German savings banks with the principles of rural banking within the general framework of Islamic values (Ahmed 1992). The bank's operation was based on the same Islamic principle i.e. no-interest to the depositors or from the borrowers. Unlike the Pakistani bank, the borrower had to have deposits in the bank in order to request a loan. The experiment soon became successful; more branches were opened in different parts of the country, and the amount of deposits increased. Hence, what started as a single bank operation expanded to form a network of local savings banks. Although the project made a good start and initial results were more than encouraging, it suffered a setback owing to changes in the political atmosphere. Nevertheless, the project was revived in 1971 under the name of Nasser Social Bank. This was the first Islamic bank in an urban setting based in Cairo. The bank is a public authority with an autonomous status. Its purpose was mainly to promote social concerns such as granting of interest-free loans for small projects on a profit-loss-sharing basis, and assistance to the poor and needy students for university and higher education. Because of these social functions, Nasser Social Bank was granted an exemption from the Banking and Credit Law of 1957 in its initial stages.

The bank was originated under the Ministry of Treasury but it is now functioning under the Ministry of Social Welfare and Insurance. Its capital comes from the funds allocated by the President from extra budgetary resources, appropriation from the state budget, and contribution from the Ministry of Awqaf (Ahmed 1992). The principles of operation of the Naser Social Bank are very similar to those of the Mit Ghamr Savings Bank. However, the latter offers a full range of normal banking services and a wide range of investment activities through equity participation (Ashker 1987, pp.18-35).

2.4 Tabung Hajji: a successful attempt

Islamic banking, with a very different approach contemporary to that in Egypt, emerged in Malaysia. It was a financial institution developed for the pilgrims of Malaysia. These institutions were established in response to what was the contention of the Malaysian Muslims that money spent on pilgrimage must be clean and untainted with 'Riba'. Since this was not possible by depositing money with the ordinary banks, a special financial institution had to be created. Consequently, Pilgrims Saving Corporation was established in 1963, which was later on incorporated into the Pilgrims Management Fund Board (Tabung Hajji) in 1969 (A. Ahmad 1993).

2.5 Other attempts

Next to follow was the Dubai Islamic Bank in 1975. The Dubai Islamic Bank is a public limited company having its office at Dubai, U.A.E. with capital of 50 million Dirhams. Since then, a number Islamic banks and financial institutions have been established in different parts of the world and have been functioning successfully.

A significant development in Islamic banking has been the granting of an Islamic bank license in Saudi Arabia to the fifty-year old "Al-Rajhi Company", a firm noted for its currency, exchange and commercial activities, whose assets exceed $5 billion. The firm started operation in 1985 under the name of "Al-Rajhi Banking Investment Corporation" and has since developed active relationships with major manufacturing and trading companies in Europe and several U.S. corporations. The emerging success of Al-Rajhi in operating profitably in different regions of the world has increased pressure on the Saudi government to go for full-fledged Islamic banking (Mangla, Uppal & Swamy 1988, p.54).

An example of multi-cooperation at the government level in the field of Islamic banking, is the Islamic Development Bank, which was founded in 1975 as a multi-national corporation by several Muslim countries. The purpose of the bank is to support social and economic development in Muslim nations within an Islamic Framework. The subscribers of the capital are the founder governments and, as such, it was established by government treaty.

In addition, an Islamic bank/investment company was established in Bahamas in 1977 as a multi-national holding company under the name of Islamic Investment Company, ICC limited. Its purpose was to establish 'Mudaraba' (partnership companies) in various parts of Islamic countries. The company has established two 'Mudaraba' subsidiaries in Sharjah and Pakistan.

A second example of Islamic banking in the West comes from Luxembourg, where the Islamic Banking System International Holding was established in 1978 as a joint-stock company. Its purpose was to establish international Islamic banks in different parts of the western countries where there are communities of Muslims, and to participate in investment projects in Islamic and non-Islamic countries. The company's investment operations are spread over different parts of the world. As a holding company, it established a new affiliated company in London in June 1983 under the name of Islamic Finance House, and another in Denmark in 1982 under the name of the Islamic Bank International of Denmark.

Dar-al-mal-al-Islami (DMI), based in Geneva, was established in 1981. DMI aims to foster an Islamic financial system based on equity and social justice by incorporating three types of institutions - banking, investment and insurance. Thus, DMI may be considered as a major multi-national company, the activities of which consist of Islamic investments, Islamic solidarity (insurance) and Islamic banking operations (Ashker 1987, pp.18-35). DMI group has adopted a high profile and ambitious campaign to open an Islamic bank and investment in over thirty countries.

The second major group is the Kuwait Finance House (KFH). It was established in 1978. The Kuwait government and the remainder by private Kuwait investors own Forty-nine percent of the KFH. Total value assets of KFH at the end of 1987 was $3.92 billion with a deposit of $3.62 billion. The source of KFH's liquidity is cheap deposits from faithful Muslims. The group has concentrated on large scale project financing, particularly in real estate. The KFH does have a minimum account size and, therefore, it could be argued that the institution only caters to the richer members of the society.

Another dynamic Islamic banking conglomerate is the 'Al-Baraka' group, which operates banks, investment companies, financial advisory and management companies in more than a dozen countries. It launched its activities only in 1982, but the group now has a total asset of over $2.7 billion. It is considered to be one of the fastest growing Islamic enterprises. The group has operations in Tunisia, Sudan, Bahrain, Turkey, and Malaysia. It is the first group to obtain a license to launch Islamic banking in London.

2.6 Complete Islamization Efforts

A development of complete Islamization of banking at national levels had been gaining momentum since the second half of the 1970s. The movement took basically two forms. First, an attempt was made to establish Islamic financial institutions side-by-side with traditional banking. In such attempts, two types of institutions were evolved: Islamic banks were established mostly in Muslim countries; and Islamic investment and holding companies started operating in some Muslim but mostly in non-Muslim countries. These institutions claimed to be operating without interest in their transactions and competed with conventional banks to attract deposits. The majority of these institutions were established through private initiatives. Second, an attempt was made to restructure the whole financial system of the economy in accordance with the teachings of Islam. This second approach was accomplished in two distinct ways, as exemplified by the changes in Iran and Pakistan. Complete Islamization efforts of some leading countries are now discussed.

2.7 Iran

The process of Islamization of Islamic banking in Iran has proceeded in three distinct phases. Nationalization, restructuring, and reorganization of the entire banking system characterized phase one taking place between 1979 and 1982. External and internal developments did not allow the policy makers to develop a coherent plan for Islamization of the banking system, although various piecemeal attempts were made towards this objective (Khan & Mirakhor 1989).

The second phase began in 1982 and lasted until 1986. It was a phase primarily characterized by adoption of legislative and administrative steps in order to implement a clearly articulated model of Islamic banking (Iqbal & Mirakhor 1987, p.106). The law for Riba-free banking was passed in August 1983, giving a very short deadline of one year to the banks to convert their deposits in line with Islamic law and their total operations within three years from the date of the passage of the law.

The third phase, which continues till now, began in 1986. This phase defines the role of the Islamic banking system differently from the earlier phases. The system is now expected to be an integral part of the Islamic government, and thus, a direct instrument of its policies. This development is a direct result of the political debate within Iran surrounding the proper role of the government in an Islamic economy. This debate culminated in a ruling by Imam Khomini, which confirmed a highly activist role for the central government in shaping the structure of the Iranian economy and legitimized a trend in the interventionist posture of the government vis-à-vis the economy. The ruling also indirectly affirmed the use of the banking system as an instrument for promoting social and economic development.

The banking sector has been used as an instrument to restructure the Iranian economy. The restructuring was essentially directed towards the shifting of financial resources from services and consumption to the production sector in four ways. First, credit to the service sector, which constituted some 55 percent of the GDP (1984-85), has been drastically reduced to halt its expansion in the short-run and curtail its size in the mid-term. Second, using all available modes of Islamic finance to help farmers to improve and expand production has used bank credit to encourage the growth of the agricultural sector. Coupled with substantial government subsidies for seed, fertilizer, machinery, and crop insurance, the credit policy of the banking system is aimed at reviving the agricultural sector. Third, Islamic banking has been used to create incentives for the development of a co-operative sector spanning agriculture, industry, and trade. Fourth, the banking system, in partnership with the government, undertakes to finance large industrial projects and investment in social overhead capital (Mirakhor & Zaidi 1988, p.3).

2.8 Pakistan

Pakistan adopted a policy of gradual transformation of its banking system from February 1979 after several years of study and preparation by the government-appointed Council of Islamic Ideology (CII). The process started when the President of Pakistan announced that interest was to be removed from the economy within a period of three years. Three of the specialized credit institutions--the House Building Corporation, National Investment Trust, and Mutual Trust Funds of Investment Corporation of Pakistan--were to remove interest from their financing operations immediately.

Following the directive issued by the government in January 1981, separate counters were opened in the commercial banks for accepting deposits on a PLS basis. Commercial banks were instructed to create separate accounts for deposits in their interest-based operation and those received on the PLS basis. A series of directives were issued in 1981 by the State Bank of Pakistan permitting commercial banks to issue non-interest based credit to finance exports and imports of commodities, and to provide financing for trading operations and housing. In June 1984, the government announced discontinuation of dual window operations of the banking system within one year. As a result, all financial operations of the banking and financial system, except the foreign currency deposits which continue to earn fixed interest, were brought under the non-interest based modes of financing.

However, along with the change of regime the progress of Islamic banking has been constrained by lack of operating Islamic ethical norms in the business environment. The posture of the policy makers toward Islamic banking in Pakistan has been marked by a great deal of caution. The banking community has shown a reluctance to engage in medium- or long-term industrial financing on a profit-sharing basis. Islamic banking in Pakistan appears to be at a crossroads, and if there is to be further progress the regulatory and legal conditions must be such that the system will have a fair chance to perform as expected.

2.9 Bangladesh

In August 1974, Bangladesh signed the Charter of Islamic Development Bank and committed itself to reorganise its economic and financial system as per Islamic Shariah. In January 1981, Late President Ziaur Rahman while addressing the 3rd Islamic Summit Conference held at Makkah and Taif suggested, "The Islamic countries should develop a separate banking system of their own in order to facilitate their trade and commerce.

This statement of Late President Ziaur Rahman indicated favourable attitude of the Government of the People's Republic of Bangladesh towards establishing Islamic banks and financial institutions in the country. Earlier in November 1980, Bangladesh Bank, the country's Central Bank, sent a representative to study the working of several Islamic banks abroad.

In November 1982, a delegation of IDB visited Bangladesh and showed keen interest to participate in establishing a joint venture Islamic bank in the private sector. They found a lot of work had already been done and Islamic banking was in a ready form for immediate introduction. Two professional bodies -Islamic Economics Research Bureau (IERB) and Bangladesh Islamic Bankers' Association (BIBA) made significant contributions towards introduction of Islamic banking in the country. They came forward to provide training on Islamic banking to top bankers and economists to fill-up the vacuum of leadership for the future Islamic banks in Bangladesh. They also held seminars, symposia and workshops on Islamic economics and banking throughout the country to mobilise public opinion in favour of Islamic banking.

Their professional activities were reinforced by a number of Muslim entrepreneurs working under the aegis of the then Muslim Businessmen Society (now reorganised as Industrialist & Businessmen Association). The body concentrated mainly in mobilising equity capital for the emerging Islamic bank. At last, the long drawn struggle to establish an Islamic bank in Bangladesh became a reality and Islami Bank Bangladesh Limited was established in March 1983 in which 19 Bangladeshi national, 4 Bangladeshi institutions and 11 banks, financial institutions and government bodies of the Middle East and Europe Including IDB and two eminent personalities of the Kingdom of Saudi Arabia joined hands to make the dream a reality. Later, other three Islamic Banks were established in the country.

Islami Bank Bangladesh Limited (IBBL) is considered to be the first interest free bank in Southeast Asia. It was incorporated on 13-03-1983 as a Public Company with limited liability under the companies Act 1913. The bank began operations on March 30, 1983.

IBBL is a joint venture multinational Bank with 63.92% of equity being contributed by the Islamic Development Bank and financial institutions like-Al-Rajhi Company for Currency Exchange and Commerce, Saudi Arabia, Kuwait Finance House, Kuwait, Jordan Islamic Bank, Jordan, Islamic Investment and Exchange Corporation, Qatar, Bahrain Islamic Bank, Bahrain, Islamic Banking System International Holding S. A., Luxembourg, Dubai Islamic Bank, Dubai, Public Institution for Social Security, Kuwait Ministry of Awqaf and Islamic Affairs, Kuwait and Ministry of Justice, Department of Minors Affairs, Kuwait. In addition, two eminent personalities of Saudi Arabia namely, Fouad Abdul Hameed Al-Khateeb and Ahmed Salah Jamjoom are also the sponsors of IBBL. The total number of branches as of December 2001 stood at 121. The authorized capital of the bank is Tk. 500 million and subscribed capital is Tk. 160 million.

Al-Baraka Bank Limited, often called the second Islamic bank in Bangladesh, commenced banking business as a scheduled bank on May 20, 1987. It is a joint venture enterprise of Al-Baraka Investment and Development Company a renowned financial and business house of Saudi Arabia, Islamic Development Bank, a group of eminent Bangladesh industrialists and the Government of Bangladesh. The authorized capital of the bank is Tk 600 million and the paid up capital is Tk. 204.07 million. The Bank currently operates 34 branches throughout the country. Apart from extending conventional commercial banking facilities to its customers, the bank has also given substantial financial support to the development of industrial and real estate projects.

Al-Arafa Islami Bank Bangladesh Limited commenced its business as a scheduled bank on September 27, 1995. The authorized capital of the bank is Tk. 1,000 million while its paid up capital is Tk. 101.20 million. The Bank follows the Shariah principles in investment and invests its funds under Mudaraba, Musharaka, Bai-Muajjal, Bai-Salam, etc. Up to 2001, the Bank has been operating its business through 40 branches all over the country.

Social Investment Bank Limited is another bank guided by the Islamic principles. It started its journey in November 1995. Its authorized capital is Tk. 1,000 million and paid-up capital is Tk. 118.36 million. Up to September 2001, the Bank has been operating its business through 15 branches.

2.10 Islamic Banking: Some Conceptual Issues

Islamic banking has been defined in a number of ways. The definition of Islamic bank, as approved by the General Secretariat of the OIC, is stated in the following manner. "An Islamic bank is a financial institution whose status, rules and procedures expressly state its commitment to the principle of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations"(Ali & Sarkar 1995, pp.20-25). Shawki Ismail Shehta viewing the concept from the perspective of an Islamic economy and the prospective role to be played by an Islamic bank therein opines: "It is, therefore, natural and, indeed, imperative for an Islamic bank to incorporate in its functions and practices commercial investment and social activities, as an institution designed to promote the civilized mission of an Islamic economy" (Ibid). Ziauddin Ahmed says, "Islamic banking is essentially a normative concept and could be defined as conduct of banking in consonance with the ethos of the value system of Islam" (Ibid).

It appears from the above definitions that Islamic banking is a system of financial intermediation that avoids receipt and payment of interest in its transactions and conducts its operations in a way that it helps achieve the objectives of an Islamic economy. Alternatively, this is a banking system whose operation is based on Islamic principles of transactions of which profit and loss sharing (PLS) is a major feature, ensuring justice and equity in the economy. That is why Islamic banks are often known as PLS-banks.

2.11 RIBA and its basic features

The word used by the Quran concerning 'interest' is Riba. The literal meanings of Riba are money increase, increase of anything or increment of anything from its original amount (Maududi 1979, p.84). However, all increases are not considered as Riba in Islam. Money may increase in business activities as well. This increase is not at all considered as Riba. The increase, instead of being prohibited (Haram), is approved (Halal) in Islam. Islam prohibits only those increases that are charged on the loan with a prefixed rate.

Muslim scholars equate interest with Riba. In the Shariah, Riba technically refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity (Chapra 1985, p.64). In other words, Riba is the predetermined return on the use of money. In the past there has been dispute about whether Riba refers to interest or usury, but there is now consensus among Muslim scholars that the term covers all forms of interest and not only "excessive" interest (Khan 1985, p.52).

In the era of Ignorance (Jahiliah) moneylenders in Arabia charged a prefixed extra amount on their money lent out. Some of them lent goods or crops and took back prefixed extra amount on and above the principal amount. In those days the extra amount charged on the principal amount of money or goods was also termed as Riba. The term Riba in the Quran has been used in the same sense.

Imam al Rajhi describes, "During the era of Jahiliah people invested their money and charged Riba on a monthly basis, though the invested amount remained unchanged. Money so invested was called back at the time of repayment. In case of the borrower being unable to pay back, the lender extended the period of repayment enhancing the amount to be paid on and above the principal amount." Abu Bakr al Jasas writes, "During the period of Ignorance the lender and borrower came to an agreement that the borrower would pay back within a specified period the principal amount along with the agreed upon excess." Ibne Hajar Askalani says, "Excess goods or money charged on and above principal amount is Riba."

Thus, any prefixed extra amount charged on a specific amount of money or goods lent out is called Riba.

The most important characteristic of Riba is that it is the positive and definite result of money when changed. In other words, when money begets money, without being exchanged for goods or services, it is called Riba. Its basic characteristics are:

It must be related to loan;

- A prefixed amount of money to be paid when due;
- A time is fixed for the repayment; and
- All these elements for repayment are taken as conditions for loan.

2.12 RIBA and Profit

There are persons who try to equate Riba with profit. In effect, they are fundamentally different from each other as can be seen from the following:

Riba Profit

1. When money is "charged", its imposed positive and define result is Riba When money is used in trading (for e.g.) its uncertain result is profit.

2. By definition, Riba is the premium paid by the borrower to the lender along with principal amount as a condition for the loan. By definition, profit is the difference between the value of production and the cost of production.

3. Riba is prefixed, and hence there is no uncertainty on the part of either the givers or the takers of loans. Profit is post-determined, and hence its amount is not known until the activity is done.

4. Riba can not be negative, it can at best be very low or zero. Profit can be positive, zero or even negative.

5. From Islamic Shariah point of view, it is Haram. From Islamic Shariah point of view, it is Halal.

Types of RIBA

The term Riba is used in Shariah in two senses. The first is Riba al-nasi'ah and the second is Riba al-fadl. The term Nasi'ah comes from the root Nasa'a, which means to postpone, to defer, or wait, and refers to the time that is allowed for the borrower to repay the loan in return for the 'addition'. Therefore, Riba al-nasi'ah means interest on loans. The same meaning is reflected in the holy Quran in the verse "God has forbidden interest" [2:275]. This is also the Riba, which the Prophet (pbuh) mentioned when he said: "There is no Riba except in Nasi'ah".

The prohibition of Riba al-nasi'ah essentially implies that Shariah does not permit the fixing in advance of a positive return on a loan as a reward for waiting. It makes no difference whether the return is a fixed or a variable percent of the principal, or an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. The point in question is the predetermined positive return (Chapra 1985, p.57).

Chapra further pointed out that, according to Shariah, the waiting involved in the repayment of a loan does not itself justify a positive reward. There is absolutely no difference of opinion among all schools of Muslim jurisprudence that Riba al-nasi'ah is Haram or prohibited. Quoting Abd al-Rahman al-Jaziri he opines that the nature of the prohibition is strict, absolute and unambiguous. He continues to say that there is no room for arguing that Riba refers to usury and not interest, because the Prophet prohibited the taking of even a small gift, service or favor as a condition for the loan, in addition to principal (Ibid).

The second sense in which Riba has been used is Riba al-fadl. Riba al-fadl is encountered in hand-to-hand purchase and sale of commodities. It covers all spot transactions involving cash payment on the one hand and immediate delivery of the commodity on the other.

The question of Riba al-fadl arises because of a saying of the Prophet (pbuh) requiring that if gold, silver, wheat, barley, dates and salt are exchanged against themselves they should be exchanged spot and be equal and alike. It may be mentioned that the above six items did the function of money at that time. While explaining the significance of Riba al-fadl and why it has also been prohibited, Chapra provides the following arguments: On the surface it appears hard to understand why anyone would want to exchange a given quantity of gold or silver or any other commodity against its own counterpart, and that too 'spot'. What is essentially being required is justice and fair play in spot transactions; the price and the counter-value should be just in all transactions where cash payment (irrespective of what constitutes money) is made by one party and the commodity or service is delivered reciprocally by the other. Any thing that is received as "extra" by one of the two parties to the transaction is Riba al-fadl, which could be defined in the words of Ibn al-Arabi as all excess over what is justified by the counter-value. Justice can be rendered only if the two scales of the balance carry the same value of goods. The point was explained in a befitting manner by the Prophet, (pbuh) when he referred to six important commodities and emphasized that if one scale has one of these commodities, the other scale also must have the same commodity, "like for like and equal for equal". To ensure justice, the Prophet, (pbuh) even discouraged barter transactions and asked that a commodity for sale be exchanged against cash and the cash proceeds be used to buy the needed commodity. This is because it is not possible in a barter transaction, except for an expert, to accurately determine the fair equivalent of one commodity in terms of all other goods. Hence, the equivalents may be established only approximately thus leading to some injustice to one party or the other. The use of money therefore helps reduce the possibility of an unfair exchange (Ibid, pp.58-59).

It is in the above sense that all commodities exchanged in the market would be subject to Riba al-fadl. Its prohibition is thus intended to ensure justice and eliminate all forms of exploitation through 'unfair' exchanges and to close all back doors to Riba since, in the Islamic Shariah, anything that serves as a means to the unlawful is also unlawful. The Prophet (pbuh) also equated with Riba the cheating of an unsophisticated entrant into the market and the rigging of prices in an auction with the help of agents. Thus, it implies that the extra money earned through such exploitation and deception is nothing else but Riba al-fadl. People may be exploited and cheated in a number of ways and that is why the Prophet (pbuh) said: "Leave what creates doubt in your mind in favor of what does not create doubt". Inspired by this Hadith, Caliph Umar said: "Abstain not only from Riba but also from Ribah" the latter literally meaning 'doubt' which refers to income that has the semblance of Riba or which raises doubt in the mind about its rightfulness. It covers all income derived from injustice to, or exploitation of, others (Ibid, p.61).

Referring to Fakhruddin al-Razi, Chapra concludes that Riba al-nasiah and Riba al-fadl are both essential components of the verse "God has allowed trade and prohibited Riba." While Riba al-nasiah relates to loans and is prohibited in the second part of the verse, Riba al-fadl relates to trade and is implied in the first part. Because trade is allowed in principle, it does not mean that every thing is allowed in trade. Since injustice inflicted through Riba may be perpetuated through business transactions, Riba al-fadl refers to all such injustices or exploitation. It requires absence of rigging, uncertainty or speculation, and monopoly and monopsony (Ibid, p.61).

It is the considered opinion of the experts on Islamic jurisprudence that interest charged by commercial banks "is identical with the excess stipulated as an obligatory condition in the contract, which is one of the two types of usury prohibited by Islamic Shariah". Justification put forward for prohibiting this kind of usury is that it admits the possibility of fraud in transactions (Ausaf Ahmed 1995, p.16). The Shariah stands for establishing the condition that there will be no element of uncertainty (Gharar) nor of injustice (Zulm) when people enter into contracts with each other, whether these contracts pertain to real transactions of commodities or to financial transactions. Islamic Fiqh Academy established by the Organization of Islamic Conferences (OIC) in its second session held in Jeddah, Saudi Arabia, during 22-28 December 1985, declared that "any increase or profit on a loan which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay, and any increase or profit on the loan at the inception of the loan agreement, are both forms of usury (Riba), which is prohibited under the Shariah" (Ibid, p.17).

Prohibition of RIBA

On religious perspective

The religious restriction on interest is quite explicit and unequivocal. All transactions based on Riba are strictly prohibited in the Quran. The prohibition of Riba appears in the Quran in four different revelations. The first of these [30:39] in Makkah, emphasized deprivation of God's blessing for a man making interest

2.13 On socio-economic perspective

The Islamic law of prohibition of interest was originally not based on economic theory but on divine authority, which considered charging of interest as an act of injustice. Early Muslim scholars considered money as a medium of exchange, a standard of value and a unit of account but rejected its function as a store of value. Lending upon interest was prohibited because it was an act of ungratefulness and considered to be unjust since money was not created to be sought to be itself but for other objects.

Recent Muslim scholars, however, place the major emphasis of their explanation of the Law on the lack of a theory of interest. They have countered the arguments that interest is a reward for saving, a productivity of capital and an inevitable consequence of the difference between the value of capital goods today and their value a year hence. The basic arguments are summarizes below:

Interest and savings: To the argument that interest is a reward for saving, Muslim scholars (see, for example, Mirakhore 1995, pp.31-34) respond that such payments could only be rationalized if savings were used for investment to create additional capital and wealth. According to them, the mere act of abstention from consumption should not entitle anybody to a return.

Interest and the productivity of capital: To the argument that interest is justified as productivity of capital, they respond that although the marginal productivity of capital may enter as one factor into the determination of the rate of interest, interest, per se, has no necessary relation with the capital productivity. Interest, they argue, is paid on money, not on capital, and has to be paid irrespective of capital productivity. In distinguishing between interest as a charge for the use of money and a yield from the investment of capital, Muslim scholars argue that it is an error of modern theory to treat interest as the price of, or return for, capital. Money, they argue, is not capital, it is only 'potential capital' which requires the service of the entrepreneur to transform the potentiality into actuality; the lender has nothing to do with the conversion of money into capital and with using it productively.

Interest as a time value of capital: To the argument that interest arises as an inevitable consequence of the difference between the value of capital goods today and their value a year hence, they respond that this only explains its inevitability and not its rightness. Even if the basis for time preference is the difference between the value of commodities this year and the next, Muslim scholars argue, it seems more reasonable to allow next year's economic conditions to determine the extent of the reward.

Muslim scholars maintain that when a person lends out, the funds are used to create either a debt or an asset (i.e., through investment). In the first case, there is no justifiable reason why the lender should receive a return. Further, there is no justification from the point of view of the smooth running of the economy, or from the point of view of any tenable scheme of social justice. The state should attempt to enforce an unconditional promise regardless of the use of borrowed money.

If the money is used to create additional capital wealth, the question is raised as to why the lender should be entitled to only a small fraction (represented by interest rate) of the exchange value of the utilities created by the use made of loaned-out money. Justice demands that he should be remunerated to the extent of the involvement of his financial capital in creating the incremental wealth.

The elimination of interest from the economic system is intended to promote economically just, socially fair and ethically correct dealings according to Islamic principles. This harmonious trade creates powerful economic incentives, and brings about co-operation and co-participation in all walks of life. Moreover, prohibition of the practice of hoarding in the Quran applies to money also. Islam wants to make it sure that one's money is used productively for oneself and the community.

2.14 Economic rationale for eliminating Riba

The economic rationale for eliminating Riba (interest) is based on values of justice, efficiency, stability and growth.

The arguments for distributive justice are:

The industrial and/or commercial risk is shared more equitably between the entrepreneur and the capital owner.

Replacing a fixed return by a proportionate share in actual profits would ensure equitable returns to capital regardless of whether profits are high or low, and whether prices are inflationary, stable or deflationary.

Wealth would generate more wealth of its owners only when its employment in economic activities results in the creation of value added.

The arguments for efficient allocation of capital are:

Loan finance in contrast to the provision of risk capital, tends to serve the most credit worthy borrowers and not necessarily the most productive and profitable projects.

Profit-sharing arrangements harmonize the interests of the suppliers and users of capital, resulting in a joint focus on productivity.

This approach also provides for social cohesion between different classes, the motivations of which are often conflicting and opposed in the conventional system.

On the subject of stability, the argument is put forward that an interest-based economy has a built-in tendency toward inflation, because the creation of money is not related to productive investments, either at the level of the central banks or at the level of commercial banks.

2.15 Objectives of Islamic Banking

The primary objective of establishing Islamic banks all over the world is to promote, foster and develop the application of Islamic principles in the business sector. More specifically, the objectives of Islamic banking when viewed in the context of its role in the economy are listed as following:

- To offer contemporary financial services in conformity with Islamic Shariah;
- To contribute towards economic development and prosperity within the principles of Islamic justice;

- Optimum allocation of scarce financial resources; and
- To help ensure equitable distribution of income.
- These objectives are discussed below.

Offer Financial Services: Interest-based banking, which is considered a practice of Riba in financial transactions, is unanimously identified as anti-Islamic. That means all transactions made under conventional banking are unlawful according to Islamic Shariah. Thus, the emergence of Islamic banking is clearly intended to provide for Shariah approved financial transactions.

Islamic Banking for Development: Islamic banking is claimed to be more development-oriented than its conventional counterpart. The concept of profit sharing is a built-in development promoter since it establishes a direct relationship between the bank's return on investment and the successful operation of the business by the entrepreneurs.

Optimum Allocation of Resources: Another important objective of Islamic banking is the optimum allocation of scarce resources. The foundation of the Islamic banking system is that it promotes the investment of financial resources into those projects that are considered to be the most profitable and beneficial to the economy.

Islamic Banking for Equitable Distribution of Resources: Perhaps the must important objective of Islamic banking is to ensure equitable distribution of income and resources among the participating parties: the bank, the depositors and the entrepreneurs.

2.16 Distinguishing features of Islamic Banking

An Islamic bank has several distinctive features as compared to its conventional counterpart. Chapra (1985, PP.154-57) has outlined six essential differences as below:

Abolition of interest (Riba): Since Riba is prohibited in the Quran and interest in all its forms is akin to Riba, as confirmed by Fuqaha and Muslim economists with rare exceptions, the first distinguishing feature of an Islamic bank must be that it is interest-free.

Adherence to public interest: Activity of commercial banks being primarily based on the use of public funds, public interest rather than individual or group interest will be served by Islamic commercial banks. The Islamic banks should use all deposits, which come from the public for serving public interest and realizing the relevant socio-economic goals of Islam. They should play a goal-oriented rather than merely a profit-maximizing role and should adjust themselves to the different needs of the Islamic economy.

Multi-purpose bank: Another substantial distinguishing feature is that Islamic banks will be universal or multi-purpose banks and not purely commercial banks. These banks are conceived to be a crossbreed of commercial and investment banks, investment trusts and investment -management institutions, and would offer a variety of services to their customers. A substantial part of their financing would be for specific projects or ventures. Their equity-oriented investments would not permit them to borrow short-term funds and lend to long-term investments. This should make them less crisis-prone compared to their capitalist counterparts, since they would have to make a greater effort to match the maturity of their liabilities with the maturity of their assets.

More careful evaluation of investment demand: Another very important feature of an Islamic bank is its very careful attitude towards evaluation of applications for equity oriented financing. It is customary that conventional banks evaluate applications, consider collateral and avoid risk as much as possible. Their main concern does not go beyond ensuring the security of their principal and interest receipts. Since the Islamic bank has a built in mechanism of risk sharing, it would need to be more careful in how it evaluates financing requests. It adds a healthy dimension in the whole lending business and eliminates a whole range of undesirable lending practices.

Work as catalyst of development: Profit-loss sharing being a distinctive characteristic of an Islamic bank fosters closer relations between banks and entrepreneurs. It helps develop financial expertise in non-financial firms and also enables the bank to assume the role of technical consultant and financial adviser, which acts as catalyst in the process of industrialization and development.

2.17 Conventional and Islamic banking

Conventional banking is essentially based on the debtor-creditor relationship between the depositors and the bank on the one hand, and between the borrowers and the bank on the other. Interest is considered to be the price of credit, reflecting the opportunity cost of money.

Islam, on the other hand, considers a loan to be given or taken, free of charge, to meet any contingency. Thus in Islamic Banking, the creditor should not take advantage of the borrower. When money is lent out on the basis of interest, more often it happens that it leads to some kind of injustice. The first Islamic principle underlying such kinds of transactions is that "deal not unjustly, and ye shall not be dealt with unjustly" [2:279]. Hence, commercial banking in an Islamic framework is not based on the debtor-creditor relationship.

The second principle regarding financial transactions in Islam is that there should not be any reward without taking a risk. This principle is applicable to both labor and capital. As no payment is allowed for labor, unless it is applied to work, there is no reward for capital unless it is exposed to business risk (Ausaf Ahmed 1995, P.17).

Thus, financial intermediation in an Islamic framework has been developed on the basis of the above two principles. Consequently financial relationships in Islam have been participatory in nature. Several theorists suggest that commercial banking in an interest-free system should be organized on the principle of profit and loss sharing. The institution of interest is thus replaced by a principle of participation in profit and loss. That means a fixed rate of interest is replaced by a variable rate of return based on real economic activities (Mangla & Uppal 1990. pp.179-215, 185). The distinct characteristics which provide Islamic banking with its main points of departure from the traditional interest-based commercial banking system are: (a) the Islamic banking system is essentially a profit and loss sharing system and not merely an interest (Riba) banking system; and (b) investment (loans and advances in the Conventional sense) under this system of banking must serve simultaneously both the benefit to the investor and the benefit of the local community as well. The financial relationship as pointed out above is referred to in Islamic jurisprudence as Mudaraba.

CHAPTER THREE

INVESTMENT DECISIONS AND BANKING EFFICIENCY

3.1 Investment decision model

Islamic banking, for its profit-loss sharing character, is conceived as more production-oriented and growth promoting than its conventional counterpart. This is because the bank's earnings are directly linked to the earnings generated from the venture financed by it. Further, replacement of interest with the principle of profit-loss sharing increases the horizon of investment opportunity in an economy. It also promotes efficient allocation of financial resources, ensures equitable distribution of income and promotes stability in the economy. Thus, Islamic banking is efficient from most of the macroeconomic measures of efficiency. The efficiency of the Islamic banking system can best be illustrated when the investment decision-making procedures between the two systems are analyzed. This necessitates an analysis of the investment decision model.

Key Assumptions

i. The investment decision model is based on the following assumptions:

ii. This is an economy where both the conventional and Islamic banks operate side by side.

iii. Customers are well aware of the functioning of the two systems of banking.

iv. Religious considerations do not affect rational behavior of the borrowers and bankers.

v. Investment decisions in the money market are not affected by the operation of capital market.

vi. There is no change in price level.

vii. There is only one market rate of interest prevailing in the economy.

viii. There is no shortage in supply of credit in the money market.

ix. Question of moral hazard is absent.

3.2 Investment decision Model: General

The Conventional Investment Demand curve explains how investment decisions are made by firms or entrepreneurs in an economy. Rate of interest being one of the key factors in the investment decision model, Conventional banking appears to be an integral part in the investment decision-making process. Akkas keeps the structure of the investment decision model intact and extends it to meet the requirement of being a general one incorporating into it the investment decision process of Islamic banking. This is illustrated in the following figures. Fig-la represents the investment decision model under conventional banking system and Fig-1b represents the same under Islamic banking. The generalized banking decision-making process is modeled in Fig-2, which is derived by superimposing Fig-1b on Fig-la.

The horizontal axis of Fig-2 depicts the level of investment, I, at different rates of interest (r_i) for a conventional bank and financier's rate of return (r_f) for Islamic bank, which are both shown vertically. The horizontal shape of the r_i curve indicates that although the rate of interest seems to affect the level of investment inversely, it is neither related nor influenced by the rates of return of the projects financed by the bank. The downward sloping r_f (rate of profit for an Islamic bank) curve, on the other hand, is directly variable to changes in rate of return, r**.** This is because both r and r_f, maintaining almost a proportional change, are downward sloping and they meet at the zero rate of return, which is depicted at point N'.

A relation between r and r_f can be established if the ratio, l (the percentage share of r going to the borrowing entrepreneur), is known. Thus, the r_f can be measured in the following way:

$$r_f = (I - l)\ r.$$

3.3 Investment Decision: conventional banking

The bank makes a loan at a fixed rate, which includes a mark-up to cover its cost of capital. The bank is not worried about the rate of return on the project. In other words, in conventional banking, the rate of return to the bank is fixed regardless of the success of the project, which is the opposite of what happens in a PLS banking system.

Under the conventional banking framework, as depicted in Fig-la, the bank charges a fixed rate of interest to finance only those projects which have rates of return greater than or equal to the rate of interest. Thus, the conventional banking system could be termed a **Fixed Return System** and the investment decision could be stated as.

3.4 Investment decision: Islamic banking

Under the profit-loss sharing system of investment financing, the bank receives a variable rate of return as it shares a percentage of profits earned by the borrower. Though there is a consensus as to sharing losses in proportion to capital participation, some of the Muslim economists think that the ratio may vary with the application of different types of modes of financing (Hasan 1988, p.47). Thus, the Profit-loss-sharing system of investment financing may be termed a Variable Return System.

Since the Islamic banking system does not charge interest on any financing agreements, the client neither receives nor pays fixed rate of return while financing his investment. Thus, the question arises as to what actually is the allocating device that ensures optimum allocation of scarce financial resources and establishes equilibrium in the money market? Furthermore, how does the financing decision of a bank relate to the investment decision of a firm?

Regarding the formed question, the rate of interest is replaced by the rate of return in the Islamic banking system. By this replacement there is no strong theoretical reason to support the often-made a priori assertion that investment levels would decline (Haque & Mirakhore 1986, p.iii). Though there is no difference of opinion in regard to the rate of return on equity financing as a tool of efficient allocation of resources in a Zero Interest Rate Economy (ZIRE), some disagreements still persist as to the interpretation of the equilibrium condition. According to Arif, capital will flow into those sectors that offer the highest rate of profits to investors until equilibrium is reached in the all sectors (Arif 1982, pp.1-23). Kahf, on the other hand, says the equilibrium level of investment can be determined at a point where its cost equals its return (Kahf 1982, pp.107-23). While Saqr is of the opinion that equilibrium will be reached at a point where the expected rate of profit is just equal to the normal rate of profit. Each industry has its own normal rate, and rates differ according to the size of investment, time maturity, degree of risk and other related factors (Sakr 1982, pp.63-65). Jarhi's views seem to be more operational and clear. He says, that there are two robust rules for static efficiency: First is that marginal rates of return on investment must be equal in all industries. The second rule requires the use of discounting to take proper care of the time dimension of costs and benefits. The process of discounting is entirely acceptable in Islam. This is a rate of return on an alternative real investment (Jahri 1982). Further, Uzair suggests the average rate of profit prevailing in the economy should be used as the measure of opportunity cost that guides project evaluation and resource allocation in the private sector (Uzair 1982, pp.69-70).

The problem still persists as to the definitions of profit and the method of its calculation. The following discussion concentrates upon resolving these issues. The term profit in the capitalist world refers to the reward for enterprise whereas in Islamic context it is a reward that has to be divided between capital and enterprise. In other words, profit in an Islamic system consists of return of capital to the investors and the sharing of the remaining profits from the business operations. But the problem arises with the r being gross rate of return accrued from project, which includes cost of borrowing and l and 1-l being the ratios going to the financier and the entrepreneur leading to confusion in making a comparison between the first rate and the next two ratios (see Fig-3).

Generalized Investment Decision Model of Conventional and Islamic Banking Systems

However, the dilemma is not insurmountable. Since we know the rate of return per unit of investment, we may arrive at total profit. The ratios may then be applied to the total profit for the purpose of determining shares of profit going to the financier and the entrepreneur. When we know the ratios and the shares of profits, their respective rate of return against their investment may easily be calculated. When we know the financier's rate of return at each level of investment, we can derive the financier's rate of return curve, i.e., r curve.

Under Islamic banking, the financial contract specifies the following returns to the financier (bank) and the investor (borrower), respectively:

r = total rate of return

r_f = financier's rate of return i.e., $(1-l)r$ .... (2)

lr = entrepreneur's rate of return.

Assuming linearity in the movement of 'l', the financing and investment decisions under Islamic banking are shown in Fig-1b.

In this figure, the r_f curve crosses the horizontal axis at the point marked N' where $r = 0$, implying the financier's interest to finance all those projects which have rates of return greater than or equal to zero. This may not happen since financing always involves some administrative cost. If so, minimum cost of borrowing under Islamic banking will be somewhere (point M) and the zero rate of return (point N'); say, at point M' as shown above.

We find some additional features of the Fig-3. These are:

i. r_i curve is a horizontal line parallel to X-axis.

ii. r_f curve is downward sloping and meets with the r curve at its lower level compared to where r_i curve meets, and

iii. The equilibrium under Islamic banking takes place at a higher level of investment (ON^V) than that of the Conventional banking (ON^F).

Banking efficiency

Banking efficiency can be tested by employing the following tests:

- Productivity
- Allocation of resources
- Distributive justice
- Economic stability

These are now discussed one by one as:

3.5 Productivity tests

Islamic banking assists in the promotion of productive activities in many dimensions. An Islamic bank, while financing investment, confronts five types of productivity challenges in terms of its ability to affectively provide financing to society. First, how much its financing system is capable of utilizing investment opportunities that exist in an economy. Second, how far its financing system can help ensure effective performance of the projects financed by it. Third, how much the system is capable of ensuring maximum possible timely recovery of the loan financed. Fourth, how profitable are the returns from its investments. Finally, how much the system is elastic or responsive to providing financial services for the entrepreneur seeking finance. Thus a financial system, to be productive, faces five kinds of efficiency tests:

1. Investment opportunity utilization test
2. Project efficacy test

3. Loan recovery test
4. Profit maximization test and
5. Test of elasticity in financing.

Islamic banking is found to be sound in each of the efficiency test as explained below.

3.6 Investment opportunity utilization test

In testing the investment opportunity utilization capacity of the investment financing system of a bank, it is essential to know what is actually meant by the term investment opportunity and how it can be quantified so as to help to measure the bank's capacity to utilize it.

Investment opportunity means total number of projects, calculated in money terms, in an economy, which are waiting to be financed having their internal rates of return greater than or equal to zero, i.e., IRR ³ 0, assuming no cost of borrowing and non-existence of other alternative opportunities for investment. For a clear understanding of the concept we may refer to Fig-3. The vertical axis shows different rates of return of bank-financed projects while the horizontal axis indicates amount of investment that could be made at different rates of return. The downward sloping rate of return curve, r, indicates that projects available in an economy can be arranged in descending order in terms of their rate of return and can be financed as long as the rate of return is greater than zero. If so, according to Fig-3, ON' is the investment opportunity level.

Under the assumptions of zero borrowing cost and fund availability, the investment opportunity utilization test can be used to compare different types of banking systems. One useful measurement is the Fund Utilization Rate, which is measured by the ratio of employed funds as a percentage of Loanable funds and may be used as a proxy for Investment Opportunity Utilization.

Utilization of investment opportunity by conventional banking system**:** In analyzing the investment opportunity utilization capacity of conventional banking system, we may again refer to Fig-3.

It can be seen that there exists ON' level of investment opportunity. Assuming availability in the supply of investible funds, the optimum level of investment under the conventional banking framework will be determined at the point ON^F**,** where the rate of return, r**,** and rate of interest, r_i, intersect at point M.

With Or_i rate of interest the level of investment that a conventional bank is interested in financing is ON^F. Thus, projects beyond the point ON^F, while having positive rate of returns, are rejected for financing under the conventional banking system since the rate of interest exceeds the rate of return from those projects making them non-profitable for the entrepreneurs and non-viable for bank financing. That means, under conventional banking a portion of investment opportunity always remains unutilized.

At this stage, it may be convenient to divide the investment opportunity level, ON', into two zones: (i) the viable projects zone, ON^F, and (ii) the non-viable projects zone, N^FN'. The latter zone N^FN' may increase or decrease if the rate of interest changes. More specifically, the utilization of investment opportunity level may be increased (or decreased) with the decrease (or increase) in the rate of interest.

Theoretically, the viable projects zone widens when the bank reduces the rate of interest in order to utilize excess liquidity. The success of the policy depends on the stage of cyclical fluctuations the economy confronts. It has been shown that the conventional banking system has excess liquidity in the downswing phase of cyclical fluctuations just after a boom (Chisti 1985, pp.3-11). At this stage the spread between the payment commitment and cash flows reaches its highest level creating a situation in which conventional banking finds lending to be very risky. As a result, it becomes difficult for conventional banking to expand the viable profit zone by reducing the rate of interest.

There might be another plausible reason why the investment opportunity utilization range of the conventional bank reduces even further. This may result in cases where the project has a net rate of return ($r - r_i$), which is very close to zero on the left of point M. This is because of the fact that the marginal projects are severely vulnerable to cyclical fluctuations and prone to losses. That is why the rational entrepreneurs themselves avoid applying for bank financing for those projects. That means, under the conventional banking framework where entire risk is borne by the borrowers, entrepreneurs submit only those projects for financing which have the highest probability of generating a high minimum net rate of return not subject to be offset by uncertainties. If this is true, the investment opportunity utilization range o

Utilization of investment opportunity by Islamic banking**:** An Islamic bank can finance up to the level ON^V of investment, thereby utilizing the extra potential investment opportunity of N^FN^V. This is possible for Islamic banking since it can remain at least at the level of the average rate of return earned by the conventional bank by counterbalancing the losses incurred in the low profit zone (right of point P) by the excess profit earned in the high profit zone (left of point P), thereby achieving the average rate of profit as that of the conventional bank. Thus, the Islamic bank can utilize more of the potential investment opportunity remaining untapped in the economy. With a microeconomic analysis in a dynamic sense, Mukherji (1984, pp.65-66) finds that compared to a capitalist firm, the firm in a Zero Interest Rate Economy will have a high rate of growth at low profit margin.

3.7 Project efficacy test

In order for a banking system to be deemed project efficient, it must have a system in place to monitor the projects that it has financed. This is crucial because the economy has scarce resources and the banking system needs to assure that those resources are being allocated to the most profitable projects.

Conventional banking and project efficacy**:** In order to determine the project efficacy of the conventional banking system, it is necessary to identify how close the relationship the bank has with the entrepreneur to whom the loan was made. In addition, it is important to determine what type of monitoring the bank does of the ongoing project throughout the term of the loan. There are four critical activities in which the financial institution can engage in order to assure that a project has the best opportunity for success: (a) the bank needs to perform a careful analysis of the proposed project prior to making the loan; (b) the contract should be written very clearly including all the details of the proposed project and the terms and requirements of the loan; (c) the bank should verify the status of the project with each advance, to ensure that the proceeds of the loan are being used for the purpose intended and not being misappropriated; and (d) the bank should monitor the performance of the business to ensure their ability to properly service the indebtedness.

In general, the conventional banking system does engage in these four activities. Hoever, some doubt exists as to how stringently they pursue these activities, as the profitability of the bank is not tied directly to the profitability of the individual project. It is argued relies too much upon collateral for safe return of the principal and interest. Thus, it is neither committed to nor serious in the effective operation of the projects that the bank finances.

Islamic banking and the project efficacy**:** The Islamic banking system, by its very nature, is a partner in the projects that it finances. The bank's income under Islamic banking has a direct functional relationship with the profit generated from the project. In other words, bank's profit increases or decreases with the rise or fall in returns from the projects that it finances. Thus the Islamic banking system is very much concerned about the performance of the project for which it provides financing. The concern is exemplified in the following activities: (a) the bank carefully considers every loan request and assesses the profitability of the each proposed projects; (b) the bank keeps a careful eye on the installation phase of the projects; and (c) the bank continues to oversee the project as long as it is a partner to the project. These activities ensure effective implementation of the projects and ultimately a better chance for success. Thus, since in the Islamic banking system, the profitability of the bank directly depends on the successful performance of the project, the bank has a greater interest in seeing that the project is a success. Therefore, Islamic banks tend to have a higher degree of project efficiency than that of their counterparts in the conventional banking system.

3.8 Loan recovery test

This test measures the ability of a financial system to take the steps necessary to recover loans, both in the ordinary course of business and when a loan has gone into default. There are various opportunities to ensure that the ultimate recovery of a loan will be successful. Those opportunities exist in the selection process, disbursement procedures, and proper monitoring of the business to which the loan was made throughout the life of the loan. Financial systems can differ on these various points, which will ultimately decide the effectiveness of a particular system in recovering the loan. While measuring comparative productivity of the two financing mechanisms in loan recovery, the question of cost effectiveness should be duly considered.

Conventional banking and loan recovery**:** Loan recovery rate might be another criterion for measuring productivity of a banking system. The higher the recovery rate, the greater is the possibility of recycling scarce financial resources leading to increase in the productive efficiency.

Conventional banking is not as effective in this aspect of productive efficiency. Conventional banking relies heavily on collateral used to secure the loan

Conventional banking systems become complacent in the loan selection process, becoming too optimistic that the collateral will assure ultimate recovery of the loan. By looking at the collateral as the source of final repayment in lieu of looking at the prosperity of the project, conventional banking systems hinder productivity in two ways: i) productive capacity and resources need to be spent in recovering loans instead of considering new projects for investment, and ii) the cost of recovering the loan reduces the profitability of the bank.

Islamic banking and loan recovery**:** On the other hand, Islamic banking is more productive in terms of loan recovery due to its built-in profit-loss-sharing mechanism. Failure of a project not only reduces profit, but also it may lead to capital losses. A delay in the receipt of profit and capital reduces ingestible funds for further financing, which reduces the bank's productivity. Thus, the Islamic PLS system fosters loan selection based on the profitability of the project, which results in timely recovery of capital that can, in turn, be loaned to another successful project.

3.9 Profit maximization test

Another way to determine the productive capacity of a particular banking system is to measure how well it utilizes its limited financial resources. In other words, is the banking system making effective use of ingestible funds by investing the most profitable projects? A productive bank will prioritize projects from most profitable to least and will extend financing to the most lucrative projects first until it runs out of capital. This will assure the bank the highest profit. Referring to Fig-3, the most productive financing system would be the one that finances projects starting from point O and proceeds along the line ON'. Two financial ratios used to measure profit maximization are (i) Profit-Employed Fund Ratio and (ii) Profit-Loanable Fund Ratio.

Conventional banking and profit maximization**:** Conventional bank's efficiency with profit maximization may be tested in terms of the Fig-3. Assuming availability of investible funds and no alternative opportunities for investment, conventional banking can maximize its profit if it finances at point indicated by ON', where r = 0. This is impossible for conventional banking since it charges the same rate of interest irrespective of the profitability of the different projects. Any attempt at financing projects beyond ON^F will lead to pulling down the level of interest rate thus reducing total profits. With the lending rate of interest being Or_i, the profit maximizing investment level for conventional banking is thus ON^F. Therefore, the total profit (return) it earns is Or_i MN.

Conventional banking may increase the volume of its return if the lending rate rises. This takes place at a lower level of investment. What this means is that conventional banking is unable to capitalize on some projects (considered as non-viable due to high lending rate), but may be able to offset those foregone opportunities by charging the higher rate of interest on the remaining projects.

The above analysis clearly shows that conventional bank's productive efficiency in terms of investment opportunity utilization works opposite to its profit maximization efficiency criterion. Furthermore it has already been illustrated above that the investment opportunity utilization level as well as the profit maximization is affected by the low rate of recovery of the loans advanced.

Islamic banking and profit maximization**:** Profit maximizing equilibrium of Islamic banking takes place at a higher level of investment than its conventional counterpart. The economy in which Islamic banking operates is in equilibrium, according to the Fig-3, at ON^V level of investment, at point M´ where the marginal rate of return on investment is equal to its marginal cost for all banks. The equilibrium point M' is preferable to M since the average profit at the former point is greater than at the latter point.

3.10 Test of elasticity in financing

Investment financing can surely be described as a service industry. The service is provided to the entrepreneurs and ultimately to society as a whole. Entrepreneurs' borrowing needs can vary from short to long term. In addition, there may be a need for temporary credit including consumption and working capital requirements. Thus for a financing system, to be productive, it should have the capability to respond to and fulfil all of the financing needs of the entrepreneur. The elasticity of investment financing may be defined as a ratio of change in short term financing to change in total investment. Thus, optimistic about the possibility of applying profit-loss-sharing concepts to shorter-term financial needs. He feels that this can be done through the introduction of proper accounting methods that may help calculate profits generated from the use of working capital on a quarterly, monthly, or on weekly basis, which could be derived from past annual or quarterly averages (Uzair 1982). That means according to him, if properly executed, *Mudaraba* and *Musharaka* may also conveniently be used for financing even the short-term working capital needs of the entrepreneurs. However, several studies reveal that the use of these financing arrangements to provide for the spontaneous short-term financing needs of entrepreneurs is actually a very small percentage of total financing made under Islamic banking at present. Of course, it is argued that most of the PLS-banks are operating in a legal environment that does not adequately support the expansion and smooth operation of these types of financing arrangements.

As far as the business transaction (particularly trade financing) is concerned, the *Murabaha* contract is applied as an alternative to its conventional counterpart using the bills purchased and discounted method of financing. However, proponents of Islamic banking prefers limiting the extensive use of *Murabaha* for these short-term financing needs as they do not conform to the profit-loss sharing characteristics of the Islamic banking system.

Islamic banking has not yet been able to devise any alternative to consumption loan financing of its conventional counterpart. The latest development of literature on the issue suggests that banks under Islamic banking may separate a portion of its investible funds for providing interest-free loans to consumers. In these circumstances, the bank would charge the borrower a service fee.

3.11 Allocation of resources

The Islamic banking system is very efficient in allocating the resources of the economy. Allocating efficiency is concerned with the best possible utilization of the community's scarce financial resources so as to attain the maximum benefit to society. There are two broad ways to promote economic welfare in a world of scarcity: (a) prioritize the projects from most beneficial to least and allocate the resources accordingly until the resources are exhausted, and (b) meet each obligation with the least possible amount of resources (Sametz 1982, p.413).

Allocating efficiency is not only limited to prioritizing projects in order of decreasing desirability and employing resources according to that order, but also putting them to their best use since all alternatives can not be satisfied simultaneously. A question arises as to how one can be sure of the best use of funds without having a criterion of fund allocation among projects, even if he is provided with the prioritized order.

An optimum allocation of invest able funds may be achieved if (a) each project in the prioritized list is given a particular percentage weight and the funds are separated accordingly; and (b) funds intended for a particular project should be allocated in term of its profitability, assuming that all other conditions have been satisfied.

Thus in order for an investment financing system to be efficient, one must follow two criteria as far as allocating efficiency is concerned: (a) projects should be prioritized in terms of decreasing desirability, and (b) projects should be prioritized in terms of their profitability (in descending order). Thus, one must use these two criteria in order to measurer the efficiency of the conventional and Islamic banking systems.

Unfortunately, these criteria do not apply to the conventional banking system. While conventional banks take into account the profitability of the project, the collateral position, and the personal integrity of the borrowers, ultimately profits of a conventional bank are not derived from the projects that are financed. Therefore, profitability does not work ultimately as a principal criterion for fund allocation. Chapra refers to the contention of Ralph Turvey that, under Conventional banking, the rate of interest is irrelevant to investment decisions and hence should be replaced by the price of existing equipment or share prices (Chapra 1985). In Fig-3 we do not find any strong correlation between the downward slopping r and the horizontal r_i curves.

On the other hand, these criteria for asset allocation fit quite comfortably into the Islamic banking system. In addition, it is also in conformity with the Islamic welfare conditions developed by Mannan (1982, pp.43-47). This is true because the very basis of Islamic banking is profit loss sharing where profitability stands first in order among the deciding factors in selecting a project for financing. While the first criterion narrates the distributional aspect of resource allocation, the second allocates resources for their most productive utilization.

3.12 Distributive justice

The rationale behind allowing banks to use public money to finance capital investment is obviously the contribution it makes to economic development of a country. Today, economic development is not merely meant for increased production or growth in the production of goods and services. Rather it means, according to the latest evolution of the concept, growth plus equitable distribution.

A banking system may influence distribution in two stages. First, it influences distribution through the deployment of financial resources among different sectors, regions and different income groups. Secondly, it affects distribution through the incomes generated by the financing process among the participating parties (the depositors, the bank, and the entrepreneurs). Hence, in order for a banking system to be an efficient one, it should ensure equitable distribution of invest able funds among different sectors, regions and different income groups as well as distribution of risks and returns among the participating parties.

The criteria that might be used here for identifying relative distributive efficiency of the two systems of banking are as follows:

a. Classifying deposits and advances in terms of account size or, if possible, in terms of income size;

b. Interest-income or profit income ratios between the entrepreneurs and the bank, and that of the bank and the depositors; and

c. Rural-urban classification of deposits and advances.

The institution of interest gives rise to two types of distributional problems. The first one relates to the distribution of income between the bankers and the depositors. The second problem relates to income distribution among various groups of people. The first category of inequality arises under conventional banking systems because the bankers appropriate the benefits derived from the lending activity. The second type of distributional problems created by the institution of '*Riba*' results from its dampening effects on investment and employment (Rushdi 1988, pp.222-3).

It can be seen from Fig-3 that conventional banking maintains a flat rate of interest regardless of the profitability of the projects financed by it. In other words, a bank's income under the conventional banking system is, by no means, related to profit accrued from the projects that it has financed. Therefore, the bank only receives the fixed interest rate as its profit or income. The entrepreneur is the only party that will benefit from the profits of the business venture.

With regard to the risks surrounding a financing arrangement in the conventional banking system, the entrepreneur is entirely responsible for any losses that are incurred. This is consistent with the fact that conventional banks place greater emphasis on maintaining sound collateral on each loan. In this way, the bank protects return of both principal and interest on the loan as the collateral can be sold to satisfy the outstanding debt, regardless of whether or not the borrower files bankruptcy.

The conventional banks pay a fixed rate of interest to their depositors. Thus, by charging a fixed rate of interest to its borrowers, the bank can assure that it makes enough interest income to pay its depositors, meet its own operational costs and also earn a profit. This system of fixed interest rates is somewhat biased against the borrower and in favor of the bank and depositor, because the borrower's rate is determined in a way that assures profits to the other parties in the transaction.

It is important to specify the impacts of the above distribution on other efficiency considerations pertaining to conventional banking. We have illustrated earlier that marginal projects (with net rate of return closer to zero) will never be approved for financing since the entrepreneurs prefer minimizing risks. This limits investment opportunity utilization capacity of the conventional bank thereby reducing productive efficiency of conventional banking.

The income distribution scheme under conventional banking works against the goal of optimum allocation of scarce financial resources. This is because of the fact that conventional banking, instead of financing in terms of profitability of projects, diverts funds to projects with sound collateral. This results in loans being made to higher income borrowers that can meet the collateral requirements and, thus, skews the distribution of scarce resources in society to the wealthy.

Since profits are shared between the entrepreneur, the bank and depositors in the Islamic banking system, there is no bias towards any income sector. In fact, the bank welcomes profitable business ventures from all income sectors. Thus, we find a strong correlation between the incomes of these three parties. This is true whether the issue is seen either from micro or from macro viewpoint.

From a micro point of view, Islamic banks share a proportion of the profits accrued from a project implying an equitable distribution. It is because of the fact that the distribution remains unaffected by the volume of profit generated from the project and the share proportion being determined by market forces, i.e., by the demand for and supply of invest able funds (Siddiqi 1983, pp.163-64).

Seen from a macro viewpoint, the distribution remains unaltered since the Islamic bank receives a share of total profits that are simply the addition of individual profits accrued from different projects financed by the bank.

As to the distribution of income between the bank and depositors, a standard proportion (in percentage terms) is always maintained. Thus under the Islamic banking system, there is a strong correlation among the incomes of the three participating factors.

3.13 Economic stabilitys

Stability efficiency is measured by the capacity of a banking system to minimize cyclical fluctuations in an economy. The economy, by nature, is subject to cyclical fluctuations. The intensity of the fluctuations may differ from system to system. In other words, differences in the operational system of different banking systems may produce cyclical fluctuations of different scale. Here the hypothesis is that an investment financing system that produces minimum fluctuations in an economy may be considered more efficient.

In measuring stability efficiency of the two systems of banking under discussion, the model developed in line with Chisti (1985, pp.3-11) may be used. Chisti reviewed the Miller-Modigliani theorem and Kalecki's theory of investment and also went deeply into Minsky's interpretation of cyclical fluctuations. Finally he firmed up Minsky's approach to analyzing the process of cyclical fluctuations.

According to Minsky (1982), the fragility of the financial system depends on the relation between contractual commitments (which are essentially interest and the principal on debts), and the cash flows from regular operations (which are essentially profits). With respect to this relationship he classifies business firms into three groups, namely *hedge, speculative*, and *ponzi.*

For *hedge* units, cash flows are expected to exceed payment commitments on outstanding debts in every period. For *speculative* units, cash commitment on debts exceeds cash flows from regular operations only for some periods. For *ponzi* units, cash payment exceeds cash flows for almost all near term periods.

During a prolonged period of tranquillity, prices of capital assets tend to rise, and portfolio preference shifts towards more *speculative* and *ponzi* financing. This makes the economy very sensitive to interest rate variations. Thus, the cost of short-term debt in the financial structure increases and the weight of cash in the economy declines. Falling profits and rising interest costs turn some *hedge* units into *speculative* units, and some *speculative* units into *ponzi* ones.

When many *speculative* and *ponzi* units find it difficult to meet payment commitments with cash flows they issue more debts. Where it becomes increasingly difficult to meet payment commitments by emitting more debts, *ponzi/speculative* units start selling out their assets. However, when many businesses resort to generate cash by selling out their assets, it causes a fall in asset prices. If the asset prices fall to the level of the cost of production or even below, new investment virtually stops. This very low level of investment exerts pressure on profits to rise and this merry-go-round starts all over.

The above interpretation of the creation of cyclical fluctuations consolidated in Minsky's own work (Minsky 1982) is retained in the Chisti model. What Chisti has added is the interpretation of the fixed financing condition, vis-à-vis the uncertainty of profits to be mainly responsible for the gap between cash flows and payment commitments. While interpreting the fixed financing condition, Chisti agrees with the opinion that oscillations in the system are not generated by exogenous shocks; rather they are inherently produced by the system itself (Andronov, Vih and Khaikin, 1966; Minorsky, 1962). The interaction between the stimulating effect of investment and the retarding effect of the worsening financing conditions is the main force that generates the cycles. He has explained the situation by using a Phase Diagram (as in Fig-4).

In region-I, both the levels of investment and payment commitments are low. Internal funds, at this low level of investment, may be sufficient to its financing and the excess of cash flows over investment expenditures may be used to retire some existing debts. At this low level of investment, prospective returns are high which accelerates investment. This indicates the upswing of the business cycle.

In Region-II, general optimism regarding investment continues. People forecast, in this situation, high returns and high capitalization rates. As a result, prices of existing and new capital goods tend to rise with the rise in investment. Under these optimistic conditions, banks will be willing to provide more financing to meet new investment plans. The situation is such that general long-term assets are acquired by emitting relatively short-term liabilities. That means a faster rise in debt payment commitments than cash flows.

A boom in the economy characterizes region-III. At this stage, the investment level is so high that it dampens optimism regarding yields. High level of cash commitments tends to lower the capitalization factor. As a result, the prices of existing capital as well as new investment starts falling, which leads to a fall in profits, i.e., cash flows. The payment commitments, at this stage, remain at the same level as before. For many operating units it becomes difficult to meet their cash commitment with their cash flows. The gap between the two widens as businesses borrow additional funds to cover existing obligations. At this stage, banks find lending to be very risky, which makes refinancing more difficult. Therefore, given no other option, the entrepreneurs are compelled to sell their assets to generate cash to meet their payment commitments. When many adopt the same procedure, asset prices fall and the sellers have to accept capital losses. Foreclosure, bankruptcies and liquidating subsidiary companies increase during this stage. With the significant fall in asset prices, new investment virtually stops. This corresponds to Region-IV. Once the economy reaches this region the process starts again from the bottom.

In summary, it is the difference between uncertain cash flows and fixed payment commitments that is a major source of instability in the economy. The magnitude of this difference depends on the particular type of investment financing system available in the economy.

Since the concepts of cash flows and payment commitments have their different connotations in conventional and Islamic banking due to differences in their operational structure, acceleration of cyclical fluctuations in the two systems certainly differs in magnitude.

The aforementioned model can conveniently be applied to measure roles of the two banking systems in aggravating/reducing cyclical fluctuations in the economy and thereby tracing their relative stability efficiency.

Conventional banking and stability efficiency**:** The cyclical fluctuation process as depicted in the Efficiency Model clearly identifies the widening gap between the payment commitments and the cash flows as the main internal source of instability in investment. The magnitude of the instability, however, depends on the degree of responsiveness of cash flows to payment commitments. Since the payment mechanism of conventional bank (conventional banking) emphasizes maintaining of fixed rate and time of payments, the instability in investment will be higher. The conventional banking system, by nature of the fixed rate of interest structure, establishes an inflexible payment schedule. Thus, the real cause of cyclical fluctuations in an economy characterized by a conventional banking system is the fixed payment commitments with uncertain cash flows. Henry Simmons and Joan Robinson also support this view as referred to by Chapra (1985). Thus conventional banking has a built-in destabilizing element (i.e., rate of interest), which aggravates cyclical fluctuations once created in an economy.

Stability efficiency and Islamic banking**:** Islamic banking has a different cash flow and payment commitment arrangement with the entrepreneurs. Cash flows under Islamic banking are defined as yields generated from regular operation of projects (which essentially mean profits for entrepreneurs). Payment commitments, on the other hand, are promises made to the bank by the entrepreneurs to pay a certain percentage of profits generated by the project along with repayment of principal. In other words, entrepreneurs commit to pay a certain percentage of profits, not a fixed percentage of the loaned amount. Thus, entrepreneurs pay less when profit is lower, and they pay more when it is higher. Moreover, if profit is zero, they pay nothing to the bank and if there is loss entrepreneurs are not obliged to pay any profit, rather the bank shares the loss in proportion to its capital participation. This system of payment, by its very nature, results in the reduction of the spread between profits or cash flow and payment commitments. Now let us show how the payment commitment arrangement under Islamic banking helps reduce cyclical fluctuations. Let us recall the phase-diagram (Fig-4). Suppose we are in the Region I. At this stage, both the cash commitments (C) and investment (I) is low. Thus, $f > 0$; $g < 0$. The low level of investment can be financed by internal funds. Prospective yields being high, stimulates further investment.

Region II is characterized by a continuous rise in investment. Here, entrepreneurs go on expecting still higher prospective returns. This leads them to increase investment by turning to external financing. In addition they are further encouraged by the financing arrangement that part of the risk will be borne by the financier. On the other hand, financiers will be cautious in financing since they are aware that if there is any loss they will be obligated to share in proportion to their capital contribution.

In region III, the economy enters into the late stage of the boom. High levels of investment, at this stage, dampen forecasts of prospective and actual yields. However, unlike the fixed interest rate case, where cash payments remain the same, payment commitments under the Islamic banking system are adjusted to the decline in cash flows. Therefore, there is not as large a need to refinance existing debts or to take on additional debt in order to meet current payment obligations, like in the conventional banking system. Moreover, the terms of refinancing may not be as stringent as the situation that arises when a borrower is unable to meet his current obligations. Therefore, one can expect that level of investment will not fall as drastically as it does in the conventional banking system.

In Region IV, the final phase of the cycle, there is a drastic reshuffling of portfolios to generate additional cash to meet the payment commitments. This results in a sharp drop in the price of capital assets, which results in chaos in the financing industry. The main reason for this chaos is the 'spread' between cash flows and payment commitment. In the Islamic banking system, however, the difference between cash flows and payment commitments is not as drastic as in the conventional banking system. Therefore, there are not as many foreclosures, bankruptcy cases and liquidations of business assets, resulting in a more stable economy during this stage. The flexibility and the built-in stabilizing capacity of the Islamic banking system automatically adjusts the spread and keeps the capital markets and financing under control. Thus, given this natural stabilizing attribute of the Islamic banking system, it can be stated that it has higher stability efficiency than its counterpart.

CHAPTER FOUR

OPERATIONAL TECHNIQUES OF ISLAMIC BANK

4.1 Sources of Funds

The financial resources of the Islamic banks consist of ordinary capital resources comprising paid-up capital and reserves, and funds rose through borrowings from the central bank and other banks (inter-bank borrowing), and issue of Islamic financial instruments. The major part of their operational funds is, however, derived from the different categories of deposits accepted on the Islamic principles of *Al-Wadiah* (safe custodianship) and *Mudaraba* (trust financing). For the sake of ease of understanding we call these two sources as 'Primary' and 'Secondary'. These are discussed as under.

4.2 Primary Sources

Paid-Up Capital

Islamic banks are public limited companies incorporated under the companies Act, which are listed on the Stock Exchange. Individuals and institutions, local and foreign, have subscribed their capital. For example, the First Islamic bank of Bangladesh - Islami Bank Bangladesh Limited (IBBL)- is a joint venture of Bangladesh and overseas capital in the ratio of 38:62. Its local capital is owned by the Government of Bangladesh and private individuals and institutions. The overseas capital (62%) of the bank is owned by the institutions and individuals as follows.

i) Islamic Development Bank, Jeddah, Saudi Arabia
ii) Kuwait Finance House, Kuwait
iii) Bahrain Islamic Bank, Bahrain
iv) Jordan Islamic Bank, Jordan
v) Al-Rajhi Company for Currency Exchange and Commerce, Saudi Arabia
vi) Dubai Islami Bank, UAE
vii) Islamid Investment and Exchange Corporation, Qatar
viii) Ministry of *Awqaf* and Islamic Affairs, Kuwait
ix) The Public Authority for Minor Affairs, Ministry of Justice, Kuwait
x) Public Institution for Social Security, Kuwait
xi) Ahmed Salah Jamjoom, Saudi Arabia
xii) Fouad Abdul Hameed Al-Khateeb, Saudi Arabia

xiii) Islamic Banking System International holding S. A. Luxembarg

Similarly, joint-venture Islamic banks have been established in quite a few other Islamic countries like Egypt, Sudan, Senegal and Turkey. The Islamic Development Bank has also participated in the share capital (and represented in the Management Board) of a number of Islamic Banks set up in the OIC member countries in order to promote Islamic financial institutions.

The capital resources of the Islamic banks are mobilized through the issue of shares for which negotiable share certificate are used. With prior permission from the Government, shares are issued from time to time. Laws governing the shares correspond to the *Musharaka* laws of *Shariah.* The holders of shares have management (voting) right and participate in the profit/loss of the bank. The shares are transferable. In the case of the IBBL, its entire capital is denominated in the local currency - i.e. Taka, though the foreign shareholders had to pay for their shares in US Dollars.

The central bank requires the Islamic banks to have and maintain capital funds, unimpaired by losses or otherwise, in such proportion to such assets of their branches and offices as may be prescribed from time to time by the central bank by notice in writing. Capital funds mean paid-up capital and reserves and any other sources of capital as may be defined and computed in such manner as may be prescribed by notice in writing from time to time by the central bank. Banking rules of Bangladesh require that the paid-up capital and reserves together must not be less than 8-00 percent of the Islamic banks' risk weighted asset (total deposit liabilities).

Reserves

The central bank also requires that every Islamic bank shall maintain a reserve fund. Before any dividend is declared, an Islamic bank shall transfer to the reserve fund out of the net profits of each year, after due provision has been made for *Zakat* and taxation, a certain percentage of the net profits in order to build up adequate reserves. If the central bank is satisfied that the aggregate reserve fund of an Islamic bank is adequate for its business, it may by order in writing exempt the bank from this requirement for a period of one year. In Bangladesh, the IBBL besides maintaining the statutory reserve, has built up an Investment Loss Offsetting Reserve (ILOR) by appropriating 10 (ten) percent of the bank's annual investment profits.

Liquid Assets

Every Islamic bank is further required to keep at all times minimum amount of liquid assets against its deposit liabilities expressed as certain percentage of the deposits, as may be prescribed from time to time by notice in writing by the central bank. For this purpose, liquid assets mean (i) cash in bank, (ii) balances with the central bank/other designated banks, (iii) Government Investment Certificates, and (iv) such other assets as may be approved by the central bank. Failure to keep the minimum liquid assets invokes penalty for each day of deficiency.

Borrowing From Central Bank

To tide over temporary liquidity shortages Islamic banks, as member banks, are entitled to borrow from the central bank, as the lender of last resort. In such cases, IBBL does not pay interest like the conventional banks. Such borrowing from the central bank is treated as a PLS deposit with the Islamic banks and profit is paid at the rate payable on corresponding PLS deposit of the bank.

Inter-Bank Borrowing

The Islamic banks have established interest-free fund arrangements with local and foreign banks on the basis of reciprocity. Normally, under prior arrangement, the Islamic banks keep surplus funds with selected banks. When needed, these banks also place interest-free compensating balance with the Islamic bank. If balances are not equal, then periods for which funds placed are adjusted.

4.3 Secondary Sources (Mobilization Of Deposits)

Like interest-based conventional banks, the main function of Islamic banks is to mobilize savings and provide financial support to the entrepreneurs. Yet there are differences in techniques applied in the process of savings mobilization and financing investment by the two banking systems. Depositors receive interest in a predetermined rate for their deposits made with an interest-based bank. Similarly, the investors are to pay a predetermined rate of interest to the bank. The technique, thus, involves each and every partner in the transaction process (i.e. the depositor, the investor and the bank) with the element of interest. Islamic bank, on the other hand, neither pays nor receives interest from any of its transactions thereby saving everybody from the curse of interest.

Islam disapproves hoarding of savings and encourages its productive investment (Chapra 1985). It puts emphasis on savings and the productive use of savings. Thus, the bank assembles the small deposits and savings of individuals into a common pool and makes these deposits available for large investment opportunities, ensuring the productive use of society's savings.

Islamic banking is a response to such exigencies. It mobilizes savings of the common people in line with Islamic *Shariah*. Techniques employed by Islamic banks for saving mobilization are as follows.

4.4 Al-Wadiah Account

Islamic banks receive deposits in their Al-Wadiah account. This account is similar to the demand deposit account of interest-based banks. Conventional interest-based banks do not pay interest on this type of deposit account. In addition, depositors may withdraw all or a part of the funds deposited in this account without restriction. The term *Al-Wadiah* means deposit of money allowing somebody to claim the funds in the account. The bank as trustee preserves and safe keeps the funds deposited. Thus, depositors feel safe keeping their money with the bank because the bank provides assurance of returning their money on demand.

When an individual opens an *Al-Wadiah* account, he agrees to allow the bank to lend these funds to entrepreneurs seeking financing for their products or activities. In addition, the depositor understands that the bank may earn a profit from its lending activity. However, any losses incurred from this investment activity are totally borne by the bank. The depositor is not liable for any losses incurred from this lending activity.

As the depositors do not take the risk of losses with *Al-Wadiah* accounts, they are not entitled to any profit from the use of their deposits by investors. On the other hand, the bank is entitled to all of the profits, if any, as the bank bears all of the risk.

Depositors are provided with a checkbook. They can withdraw any amount up to the balance at any time. The bank may charge a fee on the account to cover transaction costs. *Al-Wadiah* Deposits are short-term funds. Due to the liquidity to the depositor, they are not a reliable source of deposits to the banks. Thus, banks have to be very careful as to what type of projects is financed.

4.5 General Mudaraba Account

Interest-based banks receive deposits from clients in return for being paid a fixed interest rate. These deposits are considered to be a loan from the depositors and, thus banks must pay a predetermined rate of interest based upon the daily average balance. So, under the interest-based banking system, the relationship between the bank and its depositors is essentially that of a debtor and creditor. In the case of checking deposits, depositors are provided with a checkbook. In most cases, a depositor may withdraw all or part of the funds on deposit at any time. In some instances, depending on the type of account, notice may need to be provided to the bank for a withdrawal of money exceeding a specified amount.

The *Mudaraba* account of Islamic banks is different from the checking account of an interest-based bank. *Mudaraba* is a form of business contract where one party supplies money and the other manages the business by investing labor and time. Profits generated from the venture are shared by both in a proportion agreed upon at the time of contract. However, in this arrangement, the financier is solely responsible for any loss that may be incurred. The financier of the business is known as *Sahib al Mal, Rabbul Mal* or owner of the capital and the manager of the business is called *Mudarib* or entrepreneur.

Banks receive deposits in a *Mudaraba* account on the basis of a *Mudaraba* contract. Generally the *Mudaraba* account is not for any specific duration. Funds deposited in the *Mudaraba* account may only be invested in *Shariah* approved ventures through the application of a legitimate Islamic method of financing. This is why these deposit accounts are given the title *Mudaraba* deposits. Specifically, in this transaction, the depositor is the *sahib al mal* and the bank is the *Mudarib*. As mentioned above, profit sharing percentages are determined at the inception of the contract. It is not uncommon for the profits generated by the investment to be distributed such that the *Sahib al Mal* would receive 50 to 75 percent of the profit and the bank would receive the difference. Islamic banks cannot reduce the ratio of the *sahib al mal*, but it can reduce its own share and increase the share of the *sahib al mal,* if it wishes. Here the relationship between the bank and the depositor is shareholder and not a debtor-creditor relationship as before.

Islamic banks receive deposits in *Mudaraba* accounts that are invested into business ventures by the bank directly or through some other third party. Any profit earned from these investments is distributed among the *Mudaraba* depositors at a predetermined percentage and the bank retains the residual amount as its profit. In the event no profits are earned, the depositors receive nothing for their deposit. In addition, should a loss be incurred, the *Mudaraba* depositors are liable to share in the losses in the proportionate share of their deposits. However, if the loss incurred is due to the fault, negligence or non-adherence of bank rules on behalf of the bank or bank personnel, liability of loss is the banks sole responsibility.

Thus, unlike the deposits in the interest based system where the interest rate return is known with certainty, the returns in a *Mudaraba* account are uncertain. The only thing that is known with certainty is that the depositor will share proportionately in the profits and losses of the lending or investing activities of the bank. In the end, the depositor can withdraw the balance in the account plus or minus any profits or losses incurred from the loans.

It may further be mentioned for the sake of clarity that *Mudaraba* depositors, in spite of being partners in the profits and losses, are not partners in the total profits and losses as in the case of bank shareholders. Rather, they are entitled to share in the profits or losses from the bank's lending activity in the proportion they actually have on deposit in the *Mudaraba* account. Some experts have recommended establishing a loss-offsetting fund in order to ensure that the money deposited by *Mudaraba* depositors is not reduced or exhausted by investments or loans that do not perform well (Ibid, p.44). This would be accomplished by depositing a percent of profits (5% or 10%) from favorable business transactions into a loss offsetting reserve account. The loss offsetting reserve account would then be used to reimburse *Mudaraba* depositors for any losses due to unfavorable business deals.

It should be noted that *Mudaraba* depositors do not share in the other sources of income to the bank such as profits from *Al-Wadiah* accounts, service charges, commissions, and other forms of income etc. Likewise, they are not liable for any losses or expenses incurred by these other banking activities either.

It is important to note that the bank is not entitled to wages, allowances or any other kind of remuneration for their time and labor spent in managing the funds deposited under *Mudaraba* accounts. However, they are entitled to reimbursement for normal and essential expenses associated with the managing of *Mudaraba* deposits.

Islamic banks distribute profit among the *Mudaraba* depositors on the basis of the average amount of money available in each depositor's account for a specific period of time such as one month, three months, six months or one year, depending on the contract.

General *Mudaraba* depositors are provided with passbooks and checkbooks. However, since the bank distributes profits to the deposit account holders, it has some regulatory control over the liquidity of the account. For example, the bank may limit the number of withdrawals allowed. The bank may require prior advance notice before withdrawing money from the account, and the bank may have a minimum required balance restriction on the account. Non-adherence to these conditions may result in the forfeiture of any profits. In addition, the bank may appropriate miscellaneous expenses to the accounts of those depositors who do not follow the account restrictions. Of course, this can only happen if the agreement includes clauses containing such restrictions. As per *Shariah* rules, *Mudaraba* depositors cannot interfere in the activities of the bank and they do not have the right to take part in the management of the bank.

4.6 Term Mudaraba Account

Interest-based banks receive different kinds of Term Deposits from the depositors. The deposits are generally for 3 months, 6 months, 9 months, one year, 2 years, or 3 years, and the bank pays a stated interest rate on each of these deposits, which varies depending on the term. In general, the bank pays a higher rate of interest the longer the term of the deposit and lower rates for shorter time periods. In addition, a higher rate of interest is generally paid on term deposits than on saving deposits. Depositors are not generally allowed to withdraw money from a term deposit until the term matures. Premature withdrawal may result in penalties in excess of the interest earned, resulting in a negative return. Once a time deposit matures, the depositor may wish to reinvest for a new term. Term deposit arrangements under conventional banks result in a debtor-creditor relation as in the case of saving deposits. The bank receives deposits in exchange for a fixed rate of interest for a specific period of time. The depositors are not provided with checkbooks on term deposit accounts, but they are given term deposit certificates and as mentioned above, are paid a higher interest rate.

Islamic banks also receive term deposit from their clients. The term deposit is, of course, altogether different from that of the interest-based banks. Fixed term deposits received by Islamic banks are called "Term *Mudaraba* Deposits". Generally an Islamic bank receives these types of deposits for a minimum period of 3 months to 3 years at the maximum. The bank invests the money, and shares any profits with the depositor based upon a percentage agreed upon at the time of contract. In the event a loss in incurred, depositors share the loss in proportion to the deposit in their account. At the end of the term the contract terminates and the depositors withdraw their money, plus or minus any gains or losses. The depositors, if they like, can again deposit their money for a new term under a new contract. No checkbook is issued against a Term *Mudaraba* Deposit, however, Term *Mudaraba* Certificate is provided to the depositor.

Since the term *Mudaraba* deposit has restrictions on the withdrawals, the bank can invest the money in projects that match the term without *concerns* of liquidity. In exchange for this benefit, the bank offers higher rate of profit to a Term *Mudaraba* Deposit than that offered on a General *Mudaraba* Deposit. In fact, the longer the term deposit, the higher the profit sharing percentage and vice versa.

Therefore, the basic difference between a term *Mudaraba* account and a general *Mudaraba* account is the specified term of the deposit. In other words, there is no specific duration or term for a general *Mudaraba* account, whereas the term *Mudaraba* deposit does have specific stated duration or term.

4.7 Special Mudaraba Account

When an Islamic bank receives a *Mudaraba* deposit for investment in some specific business, sector, or project, the deposit is called a "Special *Mudaraba* Deposit". In this case, an Islamic bank, while receiving deposits, comes to an agreement with the depositors that the money to be received will be invested in some specific business such as the fertilizer or salt business; or in some specific sector like the industrial sector, textile sector, export-import sector; or in some specific investment sector of the bank such as real estate, shipping or a special project. Profits earned from these types of specific projects are distributed between the bank and the Special *Mudaraba* depositors based a previously agreed to percentage. As before, in the event of a loss, the depositors share the loss in an amount proportional to their deposits in the account.

Special *Mudaraba* depositors will share only in the profit and loss of those particular businesses, sectors or projects for which they have deposited their money. In summary, there are three types of *Mudaraba* accounts. First, is the General *Mudaraba* account, which does not have a specified term and is not restricted to being invested in specific project. In addition, deposits may be taken out of the General *Mudaraba* account on relatively short notice. A second type of account is the Term *Mudaraba* account. Just as the name suggests, this account is a time like deposits with a specified maturity, but is similar to the General account in that it is not restricted to specific projects. Third, is the Special *Mudaraba* account. These accounts can either be readily liquid like the General accounts or fixed for a specific term like the Term accounts. In addition, these accounts are invested into specific projects or industry, which is stipulated in the contract.

4.8 Project Selection Criteria

4.8.1. What Is A Project?

An industrial project is a proposal for investing resources to develop facilities for the production of goods and services in a systematic manner. A project, whether a new venture or an expansion of the existing facility, is undertaken by entrepreneurs for the purpose of earning profit. The project proposal is prepared by the entrepreneur and submitted to the bank for financial assistance and support. As the bank's interest is linked with the earnings capability of the enterprise, it has to judge the worthiness or suitability of the project by applying suitable appraisal criteria. Any failure on the part of the bank to assess the soundness of the project would seriously affect the profitability of the enterprise. A project can be considered viable if it satisfies the various aspects of the appraisal criteria. The important criteria are discussed in Section 3 below.

4.8.2. Characteristics of a Sound Project

A sound industrial project apart from being technically and economically sound should be capable of producing early profits for both investors and the economy. They should also fit in with the long-term economic objectives of the country. The following are the general characteristics of a sound project:

a) Readiness of a market
b) Advantage in production costs compared to foreign or domestic competitors
c) Long-term value to the economy.

Generally, a technically and economically viable project with a ready market and inherent cost advantage will have a prospect of high commercial profitability to attract investors. Such a project is difficult to find but can be identified if value of the project is judged by adopting scientific criteria. The major criteria for judging the value of a project are factor intensity, the plant size and complexity, foreign exchange benefits commercial profitability and natural economic criteria. Though these criteria are valuable tools for selecting a project, other non-measurable factors like politics, institutions, attitudes, social customs and the belief climate are also important.

Project appraisal provides a rational basis for determining if a project is viable. Appraisal involves detailed investigation into the various aspects of the project. The purpose is to find out whether the project is technically, economically, financially, commercially and managerially sound. The tasks of project appraisal involves determining whether technical investigation, analysis design have been adequate, whether economic study, commercial and financial study have been well done, whether financial structure is sound and whether entrepreneurial and managerial capability of the sponsors are adequate. It also involves evaluating the value of the project to the national economy. There are no standard criteria for project appraisal. Each agency has its own standards. Its objective is to determine whether those standards are met by the project. Islamic banks may develop their own standard project appraisal criteria keeping in view the Islamic principles. The viability of the project should be judged by examining the project in the following aspects.

4.9 Criteria For Selecting a Project

4.9.1 Technical Criteria

The purpose of technical criteria is to examine whether the project is viable with regard to every engineering and technological aspect of the project's specification and process. The technical feasibility study of a project covers a wide range of activities including a study of the availability cost, quality and accessibility of all the goods and services needed to make the project a success. It includes ensuring that the raw materials, supplies of fuel, power, water, land, labor, and heavy equipment are available in abundance. Further technical study would examine the purpose and design of the project, technology used in the process of production, suitability of the machinery and equipment, availability of technical services and methods of quality control, schedule of implementations and sequence of balanced development of all related technical factors. A well-qualified engineer capable to assess the technical soundness of the project has to be appointed by the bank to review the plans to undertake the job. The technical report on the project should clearly show the appropriateness of the technology used in the production process and operation and its fitness in the coming several years. Any technological advances taking place in the industry that might affect the technical and commercial soundness of the project should be indicated in the technical report of the project. As far as machinery and equipment are concerned the appraiser should particularly examine their detail specification like the year of manufacturing, materials used in it's manufacture, life of the machine, availability of spare parts, and prospects of replacement, to ensure the quality of the machinery and equipment is up to standard.

4.9.2 Economic Criteria

Economic study of a project begins with a thorough analysis of the market for the product to be made or sold. Obviously no project can be a success unless there is market for its product. In a market study, it is necessary to find out the answers of three questions: (a) How big is the market? (b) To what extent it is likely to grow? and (c) How much of it can the project capture? To get the answers of these questions, the researcher must examine import statistics, which include domestic production of the item and the potential for growth in demand for the product. The critical factor in demand and market analysis is an estimate of the demand for specific product during the life of the proposed project. The size of demand, at any given point, is a function of several variable factors such as the composition of the market, the competition from the other sources of supply of the same product, the possibility of substitute products, income and price elasticity of demand, market responses to socio-economic patterns, distributive channels and consumption growth levels. Thus, while preparing the market report the analyst must carefully analyze these variables. Any mistake in the projection of demand may result in either excess production capacity or poor capacity utilization. In addition to these, the techniques used for market penetration as well as sales promotion methods should be examined carefully, so that actual sales do not fall short of the target.

4.9.3 Commercial Criteria

The importance of assessing commercial viability of a project cannot be over emphasized, regardless of whether the project is a new one or an expansion of an existing business. The commercial viability is measured by determining the profitability of the project. Profitability indicates public acceptance of the product and shows that the enterprise can produce competitively. Profits provide the money for repaying the debt incurred to finance the project and are the source for internal financing of expansion.

The commercial viability of the project can be determined by estimating sales revenue, operating cost and profit margin at a given level of production and under a given set of operating conditions. In addition, the analyst should do a pro-forma analysis of the cost of production and profitability taking into consideration capacity of the entire plant, product mix, selling price, unit cost of production as well. The elements of costs covered in this computation are the direct costs including raw materials, chemicals, components, power, and labor. Repairs and maintenance, plant overhead, administrative expenses, packaging cost, sales expenses, financial expenses, and depreciation costs are also important elements of the cost of production. The analyst is to examine each element of the cost of production as well as the soundness of the sales forecast and selling price in determining the profitability of the enterprise.

4.9.4 Financial Criteria

The acceptability of the project to the bank is also dependent on the financial viability of the project. The financial study involves the analysis of capital structure, working capital financing plan, cash flow potential and profitability. Detailed analysis of proposed financial statements (Balance Sheet, Profit & Loss A/C) provide a useful indication for assessing the financial viability. In addition, calculating the usual financial ratios, debt-service coverage, fixed assets coverage, break-even analysis, return of investment, internal rate of return (IRR) should be examined carefully. The return on investment should be satisfactory compared to the opportunity cost of capital. The internal rate of return should be acceptable to the bank.

4.9.5 Entrepreneurial Capability Criteria

Assessing entrepreneurial capability of the sponsor is crucially important to the financial institution as the success of the enterprise lies on his capability. The essential entrepreneurial qualities for starting and running an enterprise consist of self-confidence, ability to sense new ideas and translate them into realities, innovative and creative risk taking ability resourcefulness, profit-oriented, future oriented, hard working individuals with initiative, drive and compassion. He should also be capable of planning and managing the enterprise successfully. It is very difficult to assess the enterprising qualities of the sponsor, as there is no standard criteria to assess the enterprising quality.

The evaluation of the entrepreneur should not be limited to assessing the above entrepreneurial qualities, but also to identify that the entrepreneur has a continuous strive for perfection in the industrial activities undertaken by him. Proper evaluation of entrepreneurs may help ensure a self-sustaining enterprise. In a developing country where financial assistance is easily available to setting up new enterprises, there is an inherent risk that unless enough precautions are taken such concessions might encourage dependence on promotional agencies. While evaluating potential entrepreneurs, care should be taken to select those promoters who would not be satisfied with just setting up their own industries, but will collaborate in developing a self-sustained system which will help to further industrial growth of the economy. Managerial ability of the entrepreneur should also be carefully evaluated, as the key factor for successful business operation is the managerial efficiency.

Currently there is no formal analysis put into the evaluation of the entrepreneur at most financial institutions. In order to evaluate the entrepreneurial capability of the sponsor, a bank must develop expertise in this area. One must be equipped with the required knowledge and techniques of evaluating entrepreneurs. The capacity to access entrepreneurial capability can be gained through years of experience of interviewing candidates. One must also have a clear understanding of the methods to be adopted, the characteristic traits and dimensions to be evaluated and the limitations of the techniques. A checklist may also be used to assess the essential qualities of potential entrepreneurs. In addition, modern methods of identifying the managerial qualities and risk taking ability of the entrepreneur should also be used.

4.9.6 Managerial Criteria

Assessment of managerial capability of the sponsor is crucially important for any financial institutions before agreeing to finance a project. Many enterprises fail due to the lack of managerial skills. Therefore, it is very important to assess the managerial capability of the entrepreneur. If the entrepreneur does not posses managerial competence to run the enterprise, he may employ professional managers. Like entrepreneurial skills, there is no standard criteria to assess managerial ability of the borrower. The managerial capability of the entrepreneur/managers can be assessed by studying the past experience, educational background, specialized training, planning ability, decision making strength, and leadership quality. Managerial competence can also be measured through interview techniques, and understanding his capability with regard to planning orientation and management techniques. In order to assess the planning orientations, a series of questions with regard to his choice of the business, process and production technology may be asked. The objective is to ensure that the candidate has the required knowledge and skills to manage the enterprise.

4.9.7 Security Criteria

Every financial institution places emphasis on this aspect of the project appraisal process. The security coverage may be given by mortgaging fixed assets and freehold property, hypothetical pledge of machinery and equipment, personal guarantee of the sponsors and comprehensive insurance coverage on the project's assets and goods. It is essential to examine the title of the property and authenticity of the assets very carefully. While emphasis is placed here, it has been observed that the security coverage on a project is not an effective tool for recovering the investment. In addition, security requirements prevents a good number of emerging entrepreneurs from seeking assistance from the bank. Strict collateral requirements are not compatible with the goal of promoting entrepreneurship by the bank. The time has come for banks to find a compromise with regard to the collateral issue. Perhaps the introduction of a credit guarantee, or personal guarantee may be a solution step to the problem arising out of collateral issue.

4.9.8 Benefit of National Economy Criteria

The suitability of the project can be judged by ascertaining its contribution to employment generation, value added to the economy, import substitution and the promotion of backward and forward linkage industries. The starting point for measuring national economic profitability is the calculation of commercial profitability. To estimate the economic profitability, a series of adjustments are made in the commercial cost and revenue estimates. The adjustments can be classified into three groups:

(a) Adjustments to estimated operating cost items in which the real cost of the economy are either greater or less than the cost to the enterprise.

(b) Adjustments to estimated operating income items in which the real benefit to the economy is either greater or less than to the enterprise.

(c) Adjustments to estimated net operating income of the project to reflect measurable economic costs or benefits to the economy and from those that would affect the project as a commercial enterprise.

A project with high material economic profitability and low commercial profitability may be considered for financial assistance if such project warrants subsidy and special incentives from the government.

The overall decision on financing a project is the combined result of several sub-decisions made at various stages of project appraisal. The appraisal report on various aspects of the project provides a guideline for management who must ultimately decide the enterprise for financial assistance. If the bank has not yet developed a team of expertise to appraise the project, assistance from external competent experts may be sought to undertake this job.

4.10 Accounting System of Islamic Banks

In regard to the accounting system of the Islamic bank, it is worth pointing out that the articles which govern this system, as stated in the Bank's Law, are explained and /or detailed by the bank's Board and Management, and that these explanations are subject to the approval of the bank's *Shariah* Consultant, who must, in turn, elaborate the *Shariah* standpoint on these explanations. Some contracts from the bank's law are stated below:

4.10.1 Profits Realized From Investments

a) Profits and losses relating to financing and joint investment activities shall be separated in the accounts from the other income and expenditure relating to other activities and services offered by the bank. The same applies to the income and expenditure of investments for specific purposes, in respect of which a separate account must be kept for each particular project.

b) In regards to the profit income connected with its financing and investment activities, the bank may not adopt a method of accounting which takes into account estimated or expected profits, but it must confine itself to the profits realized in accordance with the nature of the operations which the bank finances, and in accordance with the following rules:

i) In the case of individual *Mudaraba*, the profits shall be realized on the basis of a final settlement of accounts carried out between the bank and the party utilizing the funds, such settlement should be based on actual receipt of the cash and realization of the income and should be duly approved and accepted. The profits of each year shall be entered in the accounts of the year in which such settlement is carried out, whether in respect of the complete project or a part of it.

ii) In the case of decreasing participation, the profit or income shall be realized on the basis of the net income derived from the project concerned until the end of the financial year, even if such income is not in fact received in cash, as in such event, the income realized shall be treated as money due but not received.

iii) In the case of purchasing for others on a pre-agreed profit basis, the profit shall be realized upon the conclusion of the subsequent contract and on the basis of the difference between the actual cost and the price agreed upon with the party who ordered the purchase.

iv) The various financing operations shall be charged with all the direct expenses and costs arising there from, and should not be charged with any part of the general overhead expenses of the bank.

4.10.2 Apportionment of Joint Investments

a) In order to replenish the special account for meeting investment risks, the bank shall deduct annually deducts an amount equal to 10% of the net profits realized from various investment operations during that year.

b) The amounts so deducted annually are kept in a special account to meet any losses exceeding the total profits derived from investment in that year.

c) The deduction of such percentage should be stopped as soon as the accumulative balance of this account reaches twice the paid-up capital of the Bank.

4.10.3 Distribution of Profit Between Shareholders and Investment Account Holders

There are two differing aspects regarding the distribution of profits and losses between shareholders and investment account holders of an Islamic bank:

a) Should investment accounts share in all types of revenues and expenses of the bank, or

b) Should they only participate in the revenues and expenses pertaining to their investments?

The latter expenses do not include the administrative expenses of the bank, the external auditor fees or the remuneration of the Board of Directors. Islamic banks tend to differ on the revenues and expenses that determine the return of investment accounts. These include, among other items, gains from foreign currency transactions, provisions for bad and doubtful debts and depreciation charges.

4.10.4 Distribution of Profits between the Bank and the Investors

a) The Board shall announce by public notice the general percentage of profit to be allocated to the general funds participating in joint investments. This announcement is to be made at the beginning of the same financial year and not later than the end of the first month of each year.

b) The bank, as joint investor, is entitled to the remaining percentage after the deduction of the amount allocated to the investors. The bank shall also be entitled to participate in the profits of joint investments in proportion to the amount of its own funds or the funds, which it is authorized to risk in joint investments.

c) In determining the funds participating in joint investment, priority shall be given to joint investment deposits and to the holders of Joint *Muqarada* bonds. The bank may not consider itself as a participant in financing from its own funds in excess of the amounts utilized in financing over the total balances of the investors.

The bank, as a joint investor, shall bear any losses resulting from any cause for which it is legally liable, including any cases where authority is exceeded or insufficient care or caution is exercised by the members of the Board of Directors, the managers, employees or workers of the bank. Insufficient exercise of care for which the bank is answerable shall include any cases of fraud, a4buse of trust, collusion and similar forms of misconduct which fall short of the standards of honesty expected in the management of a joint venture operated by the bank.

Losses incurred which are not attributable to misconduct involving the exceeding of authority or failure to exercise care or caution shall be deducted from the total profits realized for the year in which such losses are incurred. Any excess of losses over the profits that were actually realized during that year shall be deducted from the reserve account opened for covering the risks of investment.

If the total profits realized in the year, together with the reserves accumulated from the previous year are not sufficient to cover the losses incurred, the bank must carry out a comprehensive assessment of expected profits and losses, based on market rates, from operations which are financed by venture funds, which have not reached the stage of final settlement by the end of the financial year. If the result of such assessment indicates that the estimated profits are sufficient to cover the excess loss, the bank must carry forward the excess loss so that it may be covered from the proceeds of the expected profits when they are realized from the operations include in the comprehensive assessment.

If, on the other hand, the estimated profits are less than the excess loss, the bank may treat it as a loss carried forward, provided that the amounts withdrawn from the joint investment deposits and the joint *Mudarada* bonds shall be charged with a pro-rata of the excess loss, depending on the type of the account in each case.

The Islamic legal consultant who is appointed in accordance with the provisions of this law shall ascertain the existence of a legal doctrinal (*Fiqhi*) basis to support the charging of any loss resulting from joint investment operations to the bank.

In case of liquidation of the bank, the depositors' rights shall be dealt with as follows:

a) The rights of depositors in trust deposit accounts, and other deposited funds, which are not intended for investment and participation in investment profits, shall be settled first.

b) Next the rights of depositors in joint investment accounts shall be settled in accordance with the special conditions applicable to such accounts, as well as shall the rights of the holders of joint *Mudarada* bonds, who shall receive the same percentage as the depositors in joint investment accounts.

c) The rights of depositors in specific investment accounts, and of the holders of specific *Mudarada* bonds, shall be linked to the projects specified for each investment, and they shall bear the risk of such specific investment.

d) The rights of shareholders shall be settled on the basis of a distribution among them of the remaining fund, in proportion to the shares held by each of them.

e) The balance of the reserve account for covering investment risks shall be transferred, upon the liquidation of the bank, to the account of the charity (*Zakah*) fund to be spent for the purposes prescribed under the special law of the aforesaid fund.

4.10.5 Final Accounts, Balance Sheet, Profit & Loss Accounts

The accounts of the Bank are maintained in accordance with banking accountancy methods. The Final accounts shall be closed annually on the thirty-first day of December of every year.

The auditors who are elected in accordance with the provisions of the Articles of Association audit the Annual balance Sheet and Profit-and-Loss Accounts annually, prior to their presentation to the general meeting.

The Investment profits are distributed to investment depositors and holders of *Muqarada* bonds during the month of January of the following financial year.

The net profits accruing to the bank which are not realized until the end of the financing year shall be apportioned as follows:

a) 10% to the compulsory reserve account, until the balance accumulated in this account becomes equal to the capital of the Bank.

b) 5% to the remuneration of the members of the Board of Directors accounts, to be distributed among them in proportion to the number of meetings attended within the limit prescribed in the Company's Law.

c) Any percentage the Board may deem necessary to provide a suitable reserve to meet the various liabilities, within a maximum limit of twenty percent of the net profits of that year.

d) The balance of the profits is distributed to the shareholders in proportion to the number of shares which each of them holds.

In the case of *Murabaha* to the purchase ordered who is not obliged to fulfill his promise: If the Islamic bank finds that there is an indication of possible non-recovery of the costs of goods available for sale on the basis of *Murabaha* to the purchase order who is not obliged to fulfill his promise, the asset shall be measured at the cash equivalent (i.e. net realizable) value. This shall be achieved by creating a provision for a decline in the asset value to reflect the difference between acquisition cost and the cash equivalent value.

Potential Discount to be Obtained After Acquisition of the Asset

(a) In cases where the Islamic bank is likely, at the time of concluding the contract with the client, to obtain a discount on the asset available for sale on the basis of *Murabaha* or *Murabaha* to the purchase order, and the discount is in fact received subsequently, such discount shall not be considered as revenue for the Islamic bank; instead, the cost of the relevant goods shall be reduced by the amount of the discount. Consideration should be given to the impact this will have on both the profits of the current period and future deferred profits.

(b) The discount may, however, be treated as revenue for the Islamic bank if this is decided by the *Shariah* supervisory board of the Islamic bank. Such revenue shall be recognized in the income statement.

Murabaha Receivables

Short-term or long-term *Murabaha* receivables shall be recorded at the time of occurrence at their face value. *Murabaha* receivables are measured at the end of the financial period at their cash equivalent value. Thus, receivables are valued at the amount of debt due from the customers at the end of the financial period less any provision for doubtful debts.

4.10.6 The MIS System and the Electronic Banking

Banking services are probably the fastest growing services of the modern world. The industrial revolution was a milestone for the development of the banking industry. With the acceleration of the pace of industrialization throughout the world the growing need for financial intermediation was a reality. However, until World War-II there was no real development in this sector. After the World War was over, the banking industry played a vital role to rebuild the war-damaged countries. Japan, in particular became a unique example in this regard. The banking industry in Japan took the initiative to erect the modern industrialized Japan. But still no significant innovation was found until 1960. By February 1961, a key banking innovation occurred - the introduction of the first effective negotiable certificate of deposit (CD). The instrument was introduced by First National City Bank of New York (the present day Citicorp). The term "Liability Management" came into the banking arena after this innovation, because it permitted banks to purchase funds and thereby manage their liabilities. Since then, numerous financial and technological innovations have been introduced on an ongoing basis. While the 1960s and 1970s were a time of growth in the banking industry, the greatest number of innovations and changes (e.g. mergers, consolidations and failures) occurred over the past two decades.

4.10.7 Innovations of Financial Services and Emergence of Electronic Banking

Technological innovation in the banking sector has been manifested primarily in the form of electronic funds transfer system (EFTS or EFT systems). The basic components of EFTS are automated teller machine (ATMs), point of sale (POS) terminals and the automated clearinghouse (ACHs). Less visible than EFT, but more important to a bank's ability to operate efficiently is the bank's "back office technology" (i.e. its computer operating systems). Banking has come a long way from the times of barter trading. Modern banking uses three forms of transferring value: physical currency, checks, and in an age of technology, electronic fund transfers. However, checks are by far a dominant means of payment, but that may change in the years ahead.

4.10.8 Structures and Classification of Electronic Banking

The concept of electronic banking system is a computer-based technology for rendering banking services. Electronic banking systems can be broadly divided into two categories, namely back-office electronic banking and front-office electronic banking services. Since inception of electronic banking, it has gone through a comprehensive evolution process. The evolution of electronic banking, both front and back office systems can be grouped into three categories; first, second and third generation electronic banking.

First Generation electronic banking rendered back office services like ledger keeping, cash management and so called Management Information Systems. The front office services were cash dispensers or ATMs.

The Second Generation of electronic banking got some extended back-office services like transaction, processing (off-line), ACHs, record keeping and fund transfer systems. The front-office services that evolved during this phase were telephone bill payment, point-of-sale (POS) systems, check verification, ATMs and authorization.

The present status of the electronic banking system could be termed The Third Generation of electronic banking. This era of electronic banking enjoys back office services like on-line transaction processing, centralized processing at country level, internet banking, and inter bank transaction processing to name a few. The front-office services of this era are automatic fund transfer, on-line banking, electronic home banking, and direct deposit, check truncation, lock box check truncation, electronic fund transfer electronic check representation and internet banking

Banks to provide higher quality financial services to their customers are using information technology.

4.10.9 Need for Using Modern Technology and Appliance by an Islamic Bank

In today's advanced society it is obvious that technology is needed to render better service to bank customers. Islamic banking is no exception. Like any other bank an Islamic bank can also enjoy the following advantages by introducing modern machines and appliances in its accounting and other systems.

a) By introducing a modern system in accounting, Islamic banks can improve their customer service. In a traditional accounting system a manager has to apply a time consuming process, which involves a number of employees to supply the required information to a valued customer. In contrast, the same customer could be served with a modern system simply with the touch of a button Cashing a check would be an easier transaction for customers of the bank.
b) By introducing an electronic banking system an Islamic bank can be more competitive. It should not be forgotten that this is the age of electronic service. In this context, the sooner the Islamic banks adopt modern technology, the better for the sustainability and development of Islamic banking as an alternative banking system.
c) Presence of a well-designed MIS with fully electronic banking system will enrich the research department of Islamic banks. Research information on various banking operations will be much easier to generate.
d) A well-constructed MIS will be able to provide management with updated information on a timelier basis. Top management will be in a position to evaluate the performance of the bank both at micro and macro level without depending on the manual systems.
e) Electronic banking will save time for both bank management and the clients. Initially it may increase the transaction cost but with the passage of time the cost of transaction will go down.

f) A full MIS supported by electronic banking will uphold the image of Islamic banks. The bank will be more attractive to the modern clients.

4.11 Liquidity Vs. Profitability

Liquidity is of vital importance to the daily operations of a bank. Maintenance of a sound liquidity position of the bank is necessary to protect the bank against uncertainties of its business. But the pertinent question is that how much liquidity should be maintained to ensure the profitability of the bank? In other words, if the bank maintains a small deposit balance, its liquidity position becomes weak and suffers from a paucity of cash to make payments. On the other hand, investing released funds in some profitable opportunities can attain a higher profitability. When the bank does not have an adequate deposit reserve to cover liquidity needs it may have to sell its marketable securities to raise the necessary liquidity. On the other hand, if the bank maintains a high level of deposit reserves, it will have a sound liquidity position, but forego the opportunities to earn profit through investment. The potential profitability lost on holding large deposit involves an opportunity cost to the bank. Thus, the bank should maintain an optimum level of deposit balances, i.e., neither too small nor too large of a deposit reserve balance.

It appears that maintenance of liquidity bears both risk and return. A trade off between these two elements can minimize the conflict between liquidity versus profitability of a bank. Koch (Ibid, pp.485-86) believed that there is a short-run trade off between liquidity and profitability. The more liquid a bank is, the lower are its return on equity and return on assets, all other things being equal. Both asset and liability liquidity contribute to this relationship. The composition and maturity of funds influence asset liquidity. Large holdings of cash assets clearly decrease profits because of the opportunity cost of forgone investment income. In terms of the investment portfolio, short-term securities normally carry lower yields than comparable longer-term securities. Banks that purchase short-terms securities thus increase liquidity, but at the expense of higher potential return.

He also argued that a traditional bank's loan portfolio displays the same trade-off. Loans carrying the highest yields are the least liquid. Yields are high because default risk or interest rate risk is substantial and the investment administration expense is high. Loans that can readily be sold usually are short-term credits to well-know corporations or government-guaranteed instruments and thus carry minimal spreads. Amortized loans in contrast, may provide liquidity even though they are frequently long term because the periodic payments increase near-term cash flow.

Further the author described that in terms of liability liquidity, banks with the best asset quality and highest equity capital have greater access to purchased funds. They also pay lower interest rates and generally report lower returns in the short run. Promised yields on loans and securities increase with the perceived default risk of the underlying issuer. Banks that acquire low-default risk assets, such as US government securities, forego the risk premium that could be earned. Interestingly, many banks buy US agency securities because the incremental yield more than compensates for perceived differences in default risk relative to US treasuries. Similarly, banks with greater equity financing exhibit lower equity multipliers and thus generate lower returns on equity, even with identical returns on assets. These banks can borrow funds more cheaply because a greater portion of their assets has to be in default before they might fall.

Again he advised Bank Management by saying that liquidity planning focuses on guaranteeing that immediately available funds are available at the lowest cost. Management must determine whether liquidity and default risk premiums more than compensate for the additional risk on longer-term and lower-quality bank investments. If management is successful, long-term earnings will exceed peer banks' earnings. In addition the bank's capital will increase resulting in overall better liquidity. The market value of bank equity will increase relative to peers as investors bid up stock prices.

4.12 General Liquidity Policies

When liquidity needs are filled in an unplanned way (e.g., selling long-term investments or calling loans), shareholders' value is likely to be reduced. The damage to the shareholders' position from poor liquidity planning is particularly evident when failing to satisfy depositors' demand or not accommodating legitimate investment requests causes shortfalls. The inability of an institution to satisfy depositors' withdrawal requests can lead to severe regulatory action, culminating in assumption or liquidation and thus, the complete destruction of shareholder's value. Inadequate funding of the investment portfolio disrupts customer relationships and could permanently reduce a bank's market share. However, this is not to say that liquidity policy should be completely defensive. On the contrary, a flexible liquidity strategy includes the ability to seize unexpected profit opportunities.

Timothy W. Koch (second edition, pp.483-85) mentioned that historically, liquidity management focused on assets and was closely tied to investment policies. Under commercial loan theory prior to 1930, banks were encouraged to make only short-term, self-liquidating loans. Such loans closely matched the maturity of bank deposits and enabled banks to meet deposit withdrawals with funds from maturing loans. An inventory loan, for example, would be repaid when the borrower sold the items that coincided with the need for financing to accumulate additional inventory. A bank was liquid if its loan portfolio consisted of short-term loans.

The shift ability theory represented the next extension by recognizing that any liquid asset could be used to meet deposit withdrawals. In particular, a bank could satisfy its liquidity requirements if it held loans and securities that could sell in the secondary market prior to maturity. The ability to sell government securities and eligible paper effectively substituted for illiquid, longer-term loans with infrequent principal payments.

Around 1950 the focus shifted to the anticipated income theory, which suggested that liquidity requirements and thus loan payments should be tied to a borrower's expected income. Banks were still encouraged to invest in marketable instruments but now structured loans so that the timing of principal and interest payments matched the borrower's ability to repay from income. The primary contribution was the emphasis on cash flow characteristics of different instruments because a borrower's cash flow generally varied closely with his or her income. This encouraged the growth in amortized loans with periodic interest and principal payment and staggered maturities in a bank's bond portfolio.

According to the liability management theory, banks can satisfy liquidity needs by borrowing in the money and capital markets. When they need immediately available funds, they can simply borrow from the central bank or other commercial banks. This theory became increasingly popular as banks gained the ability to pay market interest rates on large liabilities. The fundamental contribution was to consider both sides of a bank's balance sheet as sources of liquidity.

Today, banks use both assets and liabilities to meet liquidity needs. Available liquidity sources are identified as compared to expected needs. Management considers all potential deposit outflows and inflows when deciding how to allocate assets and finance operations.

CHAPTER FIVE

WELFARE SERVICES OF ISLAMIC BANKS

5.1 Welfare Banking

If real income is not sufficient to purchase necessities of life, then welfare services become essential in a society to maintain the minimum standard of living of the people. In fact, in every society, there are many people who lack the necessary income and, consequently, face inadequate lifestyles due to unemployment and under-employment. Their condition cannot improve if welfare services remain absent and concentration wealth remains in certain segments of society. The Quran states the principle that "wealth should not circulate only among the rich" [59:7]. Irfan Ul Haq (1996, pp.170-71). opined that "this verse, revealed in the context of the utilization of state income, when read completely, asserts that such income besides being meant for necessary state expenditures, is also meant to uplift the weaker section of society and not intended to be a benefit for those who may already be well off."

The Quran also encourages people to contribute generously to social welfare and helping the needy in society. This is again clearly stated, "They will ask you as to what they should spend on others. Say (O Muhammad): whatever of your wealth you spend shall be for your parents, and for the near of kin, and the orphans and the needy and the wayfarer; and whatever good you do, verily, God has full knowledge thereof" [2: 215]. Thus the Quran establishes the general principle of generous welfare spending while encouraging sacrificial levels of spending perhaps for social crises and for conditions demanding high financial support. Thus Islam calls for the meeting of the basic needs of the poverty groups through welfare services, which might include -

- Care for others and
- Zakat

1. **Care for others:** Siddiqi (1995, pp.2-3) mentioned that care for others, or helping behavior, is another cardinal principle of Islamic economic behavior. It tempers the self-interest that is ingrained in human nature to ensure survival. It is a natural concomitant of trusteeship, since one serves the Master by caring for His people. The Prophet, peace be upon him, said: "Mankind are God's dependants, so the most beloved of people in the Sight of Allah are those who do

good to His dependants." (Mishkat, *Bab-al-Shafqah wa'l-Rahmah 'ala'a-Khalq).*

Helping behavior is required because of the interdependent nature of manhood life. There is no fulfillment in life without interaction with others; individual facility requires socialization. The exclusive pursuit of self-interest in social relations is counter-productive; it defeats its own purpose. Men serve their individual and collective interest best when each individual cares for the welfare of others while striving to protect and promote his own interest. This is what religion teaches. Those who deny it, deny religion.

Allah says, "Thus, when they are told, 'Spend on others out of what God has provided for you as sustenance', those who are bent on denying the Truth say unto those who believe, 'Shall we feed anyone whom, if (your) God had so willed, He could have fed (Himself)? Clearly, you are but lost in effort" [36: 47]. "Have you observed him who denies religion? That is he who repeals the orphan, and urges not the feeding of the needy? " [107: 1-3].

2. ***Zakat*****:** *Zakat* is one of the five pillars of Islam. In a broad sense, it is only for social welfare purposes as specified by the Quran: "The *Zakat* is (meant) only for the poor and the needy, those who collect the tax, those whose hearts are to be won over, for the freeing of human beings from bondage, for the relief of those overwhelmed by debts, for the cause of God (all priority social needs), and for the wayfarer: (this is) an ordinance from God and God is all-knowing, Wise"[9:60].

Haq (Ibid, p.179) mentioned, that "the first verse on *Zakat* [73: 20] was revealed in the early Meccan period signifying the importance of welfare expenditures in the Islamic Scheme of life. Since the Muslims were a relatively small group without formal installations, *Zakat* was given privately, without specific rules or rates. It was essentially used for two purposes: to assist the indigent and the poor and to buy the freedom of those, in slavery or bondage. In the initial Madanian period, *Zakat* was given both privately to needy individuals and families as well as to the state.

5.2 The Welfare Services of Islamic Banks

This chapter deals with both pure welfare services and non-investment services offered to the clients as well as general public.

Islamic banks, as a part of the Islamic economic system, are being operated with the objective to implement the economic and financial principles of Islam. "The objective of Islamic banking is not only to earn profit, but also to do good and bring welfare to the people" According to Islam, money, income and property belong to Allah and this wealth is to be used for the good of the society (IBBL 1995, p.7) It was mentioned earlier that welfare service might include (i) care for others and (ii) *Zakat*. Islamic banks take care of others through *Qard Hasan* (benevolent loan) financing transactions. It also mobilizes *Zakat* resources.

- ***Qard Hasan* (benevolent loan)**

Since interest on all kinds of loan is prohibited in Islam, a loan, which is to be given in accordance with the Islamic principle, has to be, by definition, a benevolent loan (Qard Hasan), i.e. a loan without interest. It has to be granted on the grounds of compassion; to remove the financial distresses caused by the absence of sufficient money in the face of dire need. Since banks are profit-oriented organizations, it would seem that there is not much scope for the application of this technique. However Islamic banks also play a socially useful role. Hence, they make provisions to provide Qard Hasan besides engaging in income generating activities. However practices differ in this respect. "Some banks provide the privilege of interest free loans to the holders of investment accounts at the bank. Some other banks have the provision to provide interest free loans to needy students and other economically weaker sections of the society. Yet, some other banks provide interest free loans to small producers, farmers, entrepreneurs who are not qualified to get financing from other sources. The purpose of these interest-free loans is to assist them in becoming financially independent or to assist in raising their incomes and standard of living" (Ausaf Ahmed 1992, p.86).

Islamic banks of Pakistan provide *Qard Hasan* loans without service charges (Ibid) Islamic banks can charge the cost of disbursement, account maintenance and recovery of these *Qard Hasan* loans, though they cannot realize excess profits. The method and schedule of repayment of these loans are determined at the time of funding the request. However, the bank must keep in mind what is convenient to its customers (Hussain 1996, p.95).

- **Mobilization of *Zakah***

A pioneering experiment putting the principles of Islamic banking into practice was conducted in Mit-Ghamr in Egypt from 1963 to 1967, in which three types of accounts were operated. A *Zakah* account was one of them. The *Zakah* account attracted the stipulated amount of *Zakah* for redistribution amongst the poor (Ausaf Ahmed, op cit, p.21). Since Islamic banks follow the rules of The Islamic *Shariah*, they have to pay Zakah on their own resources (capital assets etc.), which paved the way for mobilization of financial resources for the needy and poor. "An Islamic bank accumulates its *Zakah* in the *Zakah* fund and distributes amongst the poor as per Islamic *Shariah"* (Hussain, op cit).

5.3 Islami Bank Foundation

Social Investment Bank Ltd. of Bangladesh, a newly incorporated Islamic Bank, also has some welfare programs under its non-formal and voluntary sector of banking. Those are as follows:

(a) Rotating Savings and Credit Associations: This credit program is intended to alleviate poverty. Under this program a small number of individuals, typically six to forty, form a group and select a leader who periodically collects a given amount (a share) from each member. The money collected (the fund) is then given in rotation to each member of the group. The leader receives no special consideration (other than possibly getting the first fund). He may also get commission, who in return may assume liability for defaults. Loans are interest-free.

The popularity of this program among low and middle-income groups shows that people like to save even under trying circumstances. It also shows the potential for pooling individual savings among small farmers or micro-entrepreneurs.

This program helps to generate economic activities among the poor in the non-corporate sector. It deals with informal finance and credit packages that improves the situation of poorer families and creates local income opportunities for the people. It also discourages internal migration. At a grass root village and local level it is directed towards landless laborers, marginal farmers, fishermen, small artisans, (e.g. blacksmith, carpenter, potter and handicraft producer), urban unemployed, small traders, rural industries, and small to medium scale business enterprises.

(b) Empowerment and Humanizing Family Credit Program: Under this program, the bank is operating with a human face. For example, it offers financing of consumer durable assets for the newly married couple provided marriage is dowry free.

(c) Environmental Friendly Business Program: This credit program is directed towards small traders of Tokai (mainly street children of distressed parents) with a recovery rate of 100%

(d) Social Fund: SIBL has already established its social fund by mobilizing voluntary social saving, linked to its all Formal, Non-formal and Voluntary Sector Banking operations. SIBL has been able to mobilize a surplus Social Fund for social investment purposes in the family empowerment action program, social education fellowship program, and in the health and social services sector.

(e) Cash Waqf Certificate**:** SIBL has already introduced the Cash Waqf Certificate Scheme intended to empower the family heritage of the rich and to benefit society as a whole.. It could, be the most effective and perpetual mode of deposit mobilization and use of its profit for perpetual social investment and benefits is virtually unlimited. A waquif can choose the purpose (s) to be served by his investment from the list of 32 purposes identified by SIBL; which are related with Family Rehabilitation, Education and Culture, Health and Sanitation, Social Utility Service, or any other purpose(s) approved by Islamic *Shariah*.

5.4 Non-Investment Services of Islamic Banks

Banking is a service industry. Most services of the bank are rendered for the benefit of its customers directly or indirectly. Non-Investment Services of Islamic banks are those that are not related with general investment activities of a bank. To provide the non-investment services, a bank is not required to play the role of an investor. The income realized in return for such services will certainly be interest free. The following is a discussion of the various non-investment related services offered by Islamic banks

Collection of Negotiable Instrument: The bank takes possession of negotiable instruments from its customer for safekeeping until the date of their maturity. When payment comes due. At maturity, the bank collects the proceeds from the debtor on behalf of the customer. The benefit to the client is that they are relieved of the burden of safekeeping and collection of the debt instrument.. All classes of traders and other citizens have an opportunity to take advantage of these bank services in this regard.

If the matter is considered according to the concept of Islamic jurisprudence, it would be found that it does not contain anything which conflicts with the general guidelines. It is appropriate for a bank to receive a fee for acting in the capacity of agent on behalf of the client in safekeeping and collecting the debt. Therefore, this is a viable source of Shariah approved profit to banks.

Sale of Share: Islamic banks sell primary shares of a company registered with the Stock Exchange in exchange for a commission. This contributes to the raising of capital for a company. Companies make arrangements with Islamic Banks to issue shares for public subscriptions. These are known as "new issues" which a company intends to sell to the public. Islamic banks are the most effective method of selling the shares to the public.

Transfer of Money: Islamic banks transfer money from one place to another place as per the order of its customers through Mail Transfer (MT), Telephonic Transfer (TT), Demand Draft (DD), and Pay Order (PO). They receive a fee or commission for performing such services. Customers benefit from these services, as it helps them to fulfill their financial needs timely.

Maintenance of Budget Accounts: Islamic banks can maintain budget accounts for their customers. Laborers who earn regular monthly wage, may deposit money into a budget account. The bank pays the client's bills such as: taxes and donations for example, on the client's behalf. Thus the client benefits because his financial affairs are handled automatically and his monies are set-aside on a monthly basis to handle bills that are due quarterly or annually. In exchange the bank receives a fee for providing this service. Only the Al Wadiah Current account and Mudaraba Savings account holders can maintain budget accounts with Islamic banks.

Settlement of Transactions: Islamic banks pay Bills of Exchange, and Checks of their customers to settle transactions with third parties. Thus, financial relations between the bank and its customer, and the customer and any third party (the Beneficiary) of the bill or check are maintained.

Providing Bank Guarantee: A bank guarantee is a written agreement that guarantees the performance or payment of debt by a bank client to a third party. Under the agreement, if the customer fails to perform in the capacity stipulated, the bank is held responsible for ensuring performance or payment of debt. . Islamic Banks provide this guarantee based upon cash held on deposit by taking a mortgage on other assets. In some cases the bank can act as a guarantor taking a partial mortgage on an unsecured basis. Some Islamic Banks receive a commission based on the lower of 2% or 3% of the amount guaranteed or simply incidental expenses.

Account Maintenance Activities: The opening of an account is the beginning of the relationship between a banker and a customer within the framework of banking deposits. The account is established with a standard proforma contract, which must be signed by the customer who wishes to deal with the bank concerned. A number of subsidiary operations are related to the account opening operation, such as the receipt of deposits into the account, payment of checks drawn on the bank and the execution of bank transfers and payment orders. Furthermore, among the services rendered, the bank must prepare and communicate to its customer periodic statements of the account.

A non-usury bank is able to render these services in full and to receive fees commensurate with the costs involved.

Safe Custody: A safe custody account is a small box, which is maintained in a secured area within the bank. This box is adjoined to other boxes belonging to other customers of the bank. Each box has two keys. The banker has a key and the customer has a key. Both keys must be used simultaneously to open the safe custody box. Thus, the client is assured his assets are safe in the custody box due to the dual control. Clients may access their box during normal business hours and can step into a private room in order to add items of value to the safe custody box or remove items from the safe custody box.

Islamic Banks charge a relatively low fee for this service. The main objective of offering this service is one of convenience which the bank hopes will attract additional customers.

Opening of L/C: Islamic Banks also offer Letters of Credit (L/C) for domestic and international trade on a commission basis. Thus, they facilitate business relationships between importers and exporters through this service.

Issue of Solvency Certificate: Islamic banks issue solvency certificates to their customers as per an order received. This certificate is required for business purposes, to acquire assets on an installment basis, or to go abroad for study.

Business Advising Service: Islamic Banks can provide business-advising services

(BAS) to its clients as well. The bank offers counseling on technological issues, marketing and other important business information to industrial entrepreneurs of small and medium sized business of any nature. A banker should be an expert in banking as well as in business to provide BAS. Moreover, he will conduct an extensive survey of the customer's business.

Transaction of Foreign Currency: Islamic banks buy and sell foreign currencies. They allow their customers to draw local currency against foreign currency deposited in a foreign currency account with the bank.

Publication Works: Islamic banks publish books, journals, booklets, pamphlets to advertise the bank's services. Important information related to trade, commerce and industry are published in these forums to address the needs of the banks customers. Such services have created social awareness about Islamic banking in the economy. Today, more people are familiar with the terms of Islamic banking like Bai-Murabaha, Mudaraba, and Musharaka. In addition, they also know the special features of the Islamic Economy.

Exchange of Information: Islamic banks exchange information with other banks, organizations and individuals pertaining to the credit worthiness of its customers. In addition, banks seek this information prior to extending a loan to a prospective customer. Thus the bank can be assured it has made a good decision on whether or not to make the loan to the customer.

Financial help: Islamic banks provide financial help to different organizations through paid advertisements describing various services that the bank offers. These advertisements increase the competitiveness of Islamic banking products in the market by creating awareness among the people.

Computer Service: Like other commercial banks, Islamic banks also provide computer services to process investment proposals, check clearance, statement preparation, and account maintenance. It can handle dividend payments of a company and can send reports to the company electronically. Use of computers provides various responsive services to its customers.

Use of Automatic Teller Machine: Islamic banks offer Automatic Teller Machines (ATMs) to allow customers access to their accounts after the banks are closed. The ATM provides service twenty-four hours a day, and seven days a week.

Peter J. Hall and B. Julian Beecham (1987, p.150) mentioned that to use the ATM service a customer is given a plastic card, which may be linked to a current account, credit card, or be restricted solely to ATM usage. It is electronically imprinted with the customer's branch and account number. The customer inserts the card into a machine and on a keyboard he taps out his personal identification number (PIN). The card will only operate if the correct PIN is keyed in thus safeguarding the customer and the bank in the event of loss or theft of the card. Having inserted the card and keyed in the correct PIN, the customer then has a variety of services offered by the ATM. Cash dispensing is the most important but, in addition, most machines allow check books to be ordered, account balances to be obtained and statements to be ordered.

Issue of Qard Cards: Islamic banks can issue Qard Cards (QC) unto certain limits to their valued customers. The card will enable a holder of it to purchase goods from the market without cash or a check. The merchants indicate clearly which cards they will accept. At the point of purchase, the Cardholder presents his card to the merchant who runs the card through a special machine, which imprints account information on a form to be signed by the Cardholder. Thus, a customer can make his purchase without having to pay cash on the spot. In addition, the (QC) can also be used like an ATM card at participating banks.

The seller then presents the form signed by the Cardholder to the Card-issuing bank for reimbursement of the sale to be deposited into his account. Ultimately, the cardholder receives monthly invoices for the total amount of goods purchased during the month on the QC. This amount is usually payable to the card-issuing bank at some prescribed date in the future. To be consistent with Islamic law, no interest is charged on the service. However, the bank can accept service charges against the issue of a QC. Once the QC is issued, it has no expiration date and can be used until the cardholder requests it to be cancelled. Thus, Qard Hasana facilities are usually given to the most dignified customers of the bank.

Issue of Travelers Checks: Islamic banks also issue Travelers Checks (TC). These are special types of checks drawn on the issuing bank and signed by the person to whom they are issued. The issuing bank guarantees the payment of these checks . Thus, it is accepted worldwide without a question. When the item is presented for payment, the person to whom it was issued needs to countersign it. The signature should be similar to the one that already appears on the check. Normally a passport is required as proper identification when the check is being used for payment. If a TC is lost or stolen it can be replaced again through a local branch/agent of the issuing bank subject to verification of the signature.

Factoring Service: The factoring agreement covers assessment of creditworthiness of all potential buyers and provides complete protection against bad debt, provided the credit limits are not exceeded. The small and medium sized business houses benefit from this service of Islamic banks. In exchange for this service, these businesses pay a service charge or commission to the bank. As part of this service, the bank will maintain sales ledger records, and control the finances of the client's business house. This makes business easier for the wholesalers.

Night Safe: Night safe (Ibid, p.158) facilities represent a short-term bailment. The customer is given a key, which enables him to operate a specially constructed metal door on the outside of the bank premises. A wallet is provided and cash may be placed in the wallet and deposit in the safe for overnight safe - keeping. The customer then collects the wallet during the bank's business hours and deposits the money into his account. Alternatively, the bank may be authorized to open the wallet and deal with the contents according to the customer's instructions. The night safe service is potentially useful to business customers who accumulate large amounts of cash after the bank is closed and do not want to hold the cash until the next morning when the bank is open.

Home Banking Service: This service may be provided with a combination of a television, computer and a telephone in which a customer can transfer money from one account to another, obtain his account's details and issue necessary instructions regarding standing orders. It provides convenience to those customers who do not have time to deal directly and personally with the bank.

School Banking: A mobile unit of an Islamic bank branch travels to area schools on a weekly basis. Students make small deposits into a bank account. Thus, the students save money from their Tiffin expenses. In addition, children develop a thrift habit at an early age and the bank collects deposits to be used for investment purposes. In addition, school banking teaches children and their guardians about all of the banking services available at the bank.

CHAPTER SIX

BANKER CUSTOMER RELATIONSHIP

6.1 Customer Relation

The relationship arises between a banker and a customer with the opening of an account by the customer with a banker. The application for opening an account is considered as a letter of agreement for establishing the banker-customer relationship. The general view is that the banker-customer relationship is mainly that of a debtor and a creditor with certain special features.

However, today the range of banking services is more extensive, and indeed is expanding all the time, so it must be expected that other relationships will arise besides that of debtor and creditor. For instance, the relationship of principal and agent is present when the customer instructs his bank to buy or sell stocks on his behalf, and when items are held in safe-custody the relationship is that of bailer and bailee. Where the bank's executorships service takes on the administration of a deceased's estate the relationship is that of trustee and beneficiary. Duties akin to a trusteeship might also happen when a branch comes into possession of funds or property that belongs to a third party, as when the bank has sold property in mortgage, and has a surplus to pass to the subsequent mortgagee. Obviously the relationship with the customer in that situation is that of a mortgagor with a mortgagee. However, if the security had been given by a third party then another state of affairs would exist between the lender and his surety. There, duties and obligations would arise irrespective of the banker-customer relationship with the borrowing customer.

The nature of the relationship depends upon the type of services rendered by the banker, which has two aspects: one is legal and another is behavioral.

It is worth mentioning that the behavioral relationship is important from the view point of humanity, particularly for the customers who do not maintain account with the banker but buys, miscellaneous services like Demand Drafts, Mail Transfer of money or payment of electric bill, gas bill, opening and renewal of licenses of Television, and Radio. For example, a bankers' good manners, courtesy, kindness, sympathy, and cooperation in helping to solve a customer's problem, undoubtedly makes a good impression on the customer. The roads to progress and prosperity can easily be made through friendly behavior with the customers. If the bankers wish to develop their organizational image, they have to offer better services and cooperation, coupled with courteous service to gain a competitive edge.

The history of conventional banking reveals that these relationships have arisen on the basis of interest. However, interest is prohibited in Islam. It has been explicitly stated in the Holy Quran that "Trading is permitted but Riba is forbidden" [2: 275] It should be mentioned here that Riba usury and interest mean the same thing. By the elimination of interest from the transactions and with the introduction of banking based on Islamic Shariah (jurisprudence) the relationships took new dimensions.

6.2 Bankers and Customers

Section 3(b) of the Negotiable Instruments Act-1881 defines a banker as a person transacting the business of accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by check, draft, order or otherwise, and includes any Post Office Savings Bank.

There is no statutory definition of a 'customer' and one must turn to case law if any legal guidance is required as to what features need to be present to constitute a person being considered a customer of a bank. The Negotiable Instruments Act has not clearly defined a "Customer", but it appears from Section-131 of the Act that constituents of the Bank who maintain some type of account(s) with him duly introduced for the purpose of having a certain amount of deposits therein withdrawable by checks or by any other means, are customers. More recently, however, where a bank gave investment advice to a person who was not in an account at the time, the court held that nevertheless the bank had incurred responsibilities to him, as to a customer (Woods vs. Martins Bank Ltd. 1959). It may be said, therefore, that a person becomes a customer as soon as a business relationship is established. It is not necessary for the account to have been open for a long period of time, or for the business to be conducted over a regular period. In fact, two conditions seem to be important for becoming a customer of a bank. These are as follows:

(i) There has to have been some habit of dealing between him and the banker with or without opening an account; and

(ii) The transactions so made ought to be in the nature of regular banking business.

A bank can even be a customer itself, where it has an account with another bank.

6.3 Responsibilities of Bankers to Customers

Both parties in this relationship, both banker and customer have certain responsibilities to one another. The Banker's responsibilities to his customers are as follows:

(a) Negotiable Instruments Act-1881, Section-31 indicates that a banker must pay the customer's check which has been drawn duly on his account subject to the availability of money in the Account; general banking duty of a banker. If these negotiable instruments are returned back without clearance, the bank should quickly inform the customer.

(b) Maintenance of secrecy of a customer's Account is the legal and moral responsibility of a banker, both while the account is open and even after it has been closed. Of course, secrecy may be disclosed:

- Against the order of the court of law or to the police and Income Tax authority;
- To serve the public interest; and
- Against the request of the customer in black and white.

(d) The bank is entitled to a charge and or commission, except where special arrangements have been made. It is entitled to debit the customer account with charges, usually quarterly, or semi-annually without specific advice to the customer. A charge for an item such as the stop payment of a check or rejection of a check would usually be allowed.

(e) A bank must always follow its usual course of business when acting for its customers who can expect transactions to be dealt within a consistent manner.

(f) A bank acquires a general lien over its customer's negotiable documents, which come into its possession, unless an express contract has been made which would be inconsistent with a lien (Brandao v. Barnett, 1846).

(g) The bank must give reasonable notice to its customer before closing an account that is maintained on credit. However, overdrafts are repayable on demand, unless there is an implied or actual agreement to the contrary.

(h) Supply of Pass Book or Statement of Account is the duty of a banker.

(i) If any fraudulent check comes to the hand of a banker, he should inform the customer immediately.

(j) The bank must repay the whole or part of the balance, if and when there is demand by the customer during banking hours, provided the demand is made at the branch where the amount is kept, or at a branch where prior alternative arrangements have been made, such as under credit-opened encashment facilities.

(k) A bank has no obligations to third parties, arising out of the duty to pay its customer's checks, and the payee of checks issued by a customer cannot sue the paying banker.

6.4 Responsibilities of Customers to Bankers

- On the other hand, there are certain responsibilities of the customers. Those are given below:
- To ensure safety and security of the checkbook;
- To issue a check duly neither being careful to ensure that neither words nor figures can be altered;
- If a check or checkbook is lost, the customer should inform the banker immediately; and
  - Negotiable Instruments Act-1881, Sections-65 and 68 indicate that a check must be drawn upon the bank branch where the money was deposited, during regular banking hours.

6.5 Measures to Improve Banker-Customer Relationship in an Islamic Bank

Abolition of Interest from transaction: Interest is considered a main deficiency factor in the relationships of a banker and a customer, under conventional banking system. The debtor-creditor relationship of a banker and a customer is frequently threatened by this factor. The customer is obliged to pay a pre-determined rate of interest on the sum borrowed even though he may have incurred a loss. Even when a profit is made, the fixed rate of interest can prove an onerous burden if the rate of profit earned is less than the rate of interest payable. The fixed interest--based system in a loss situation could to bankruptcy in some cases. The dead weight of interest in times of a depressed economic activity characterized by low profitability makes industries "sick and makes their "recovery" extremely problematic.

Banker-Customer relationships in Islam are established on a profit/loss income sharing arrangement instead of interest. The Islamic Shariah prescribes how a society is to be organized, what will be the relationships of its members, and how the affairs of the members are to be conducted. Accordingly, the relationship between a banker and a customer was established under the Islamic banking system.

Assurance of Distributive Justice: The Conventional banking system does not ensure distributive justice of investment financing. Distributive justice means distribution of risk and returns between the financier, depositors and entrepreneurs in such a manner that no body is to receive or bear an undue share of benefit or loss. In case of bearing risks, the conventional banks shift it altogether to the entrepreneur borrower. To ensure the safe return of its principal plus interest it demands sound collaterals with the intention that if the entrepreneur for some reason is unable to repay the claims of the bank, the money can be realized from the sale of the collateral. This is a sheer injustice according to Islamic law.

While any return on capital in the form of interest is completely prohibited in Islam, there is no objection in getting a return on capital if the provider of capital enters into a partnership with a worker or entrepreneur and is prepared to share in the risks as well as the gains between them. The depositors of the bank may not be guaranteed a predetermined return on their savings, but they would be entitled to a share in the actual profits earned by the bank. Similarly, the bank would not be entitled to claim a pre-determined return on the capital provided by it to the borrower but can enter into a profit/loss income sharing arrangement with them. There are two specific profit/loss sharing financing arrangements of the Islami Bank, which are known as Musharaka and Mudaraba that can be mentioned here. In Musharaka arrangements the profits are shared in pre-agreed proportions, but the loss, if any, is shared in proportion to the capital contributed by the banker and the customer. In the Mudaraba arrangement, the banker provides capital, and profits are shared in pre-agreed proportions but losses, if any, are borne by the banker entirely. In this case, there is no financial loss to the borrower, except his labor and time.

Supply of Venture Capital: The relation between a conventional banker and a potential entrepreneurial customer is not properly established due to the fact that lending by conventional banks is collateral-oriented. It does not allow lending to a large number of potential entrepreneurs who can add to gross domestic product (GDP) by their productive endeavor but do not possess sufficient security to pledge with banks to satisfy their criteria of creditworthiness. A Conventional banker is committed to pay a predetermined rate of interest to depositors. The banks in their lending operations are most concerned about the safe return of the principal lent along with the stipulated interest. As a result, "venture capital" cannot be provided to the innovative entrepreneur, who has a new idea for creating products or services. Particularly, in agriculture, small farmers are deterred from adopting new cultivation practices on account of this reason. Collateral oriented lending means the circulation of wealth among the wealthy persons of the society that sharpens the difference between the rich and the poor. Islam does not allow this to occur. The Quran says wealth may not make a circuit only among the wealthy of you"(57: 7). Islam brought a golden opportunity to the potential entrepreneurial customer to establish a relationship with the banker without security under Mudaraba, Musharaka and other lending principles of the Islami Bank. The Islami Bank encourages entrepreneurs by providing funds to them and by agreeing to share in both profits and losses. Thus entrepreneurial activities, if pursued within the framework of the Shariah can easily contribute to the GDP. It should be mentioned here that in the Islamic system, the supplier can share profit and user of funds in any ratio as mutually agreed but loss has to be borne by the respective parties strictly according to their capital participation ratio. Shariah does not permit any variation even by mutual consent. Of Course, due allowances have been provided against loss resulting from negligence or violation of contract. The rigid Shariah provision in respect of loss is a permanent mechanism to protect the rights of the entrepreneurs. Thus we find Islamic banks have built-in institutional arrangement for establishing a fair relationship with the entrepreneur by satisfying the need of venture capital for them.

Elimination of Banking Fraud: Bank frauds are on the increase. The customers' deposited money has fraudulently been drawn from the bank. It is the banker's contractual obligation to pay depositor's money from his own sources. This resulted in deterioration of relationships between a banker and a customer. Similar is the position of advances disbursed by the banks to different types of borrowers. If some borrowers default, the Bank will bear the loss and relationships with the customers will deteriorate. Religion plays a dominant role in building up the character of men. When a person is religious, it is believed, he will remain honest and will not commit anything wrong morally. But conventional banking was not established according to the rules of religion.

Allah approved Islam as the only way of life. The Quran says, “To-day I have perfected your religion for you and completed My blessings on you and approved Islam as the way of life for you [5:16]. An Islamic bank, behind which the Islamic faith acts, is based on Islamic Shariah. So it enjoys the opportunity to employ the devoted Muslims in the banking profession. It may also increase the religious values among the customers by imparting training to them so that they possess a mind free of fraud. It recognizes that a religious man always keeps himself away from fraud.

Application of Zakat: The distinguishing feature of an Islamic bank is to build up Zakat pool out of its own resources calculated on capital and reserves. Customers also can deposit their Zakat funds to the Islamic bank Zakat pool. This arrangement of Zakat ties the religious relationship of a banker and a customer. The Zakat Fund does have a target-oriented program. The target group consists mostly of the poorest and the weakest in the society. It may be noted that Zakat is a charge on the economic assets of the rich. Hence, the Zakat-based program of the Islamic bank is a mechanism for the redistribution of the economy’s assets from the rich to the poor. As such, it widens the relationship of the banker and the customer.

Rendering Improved Customer Service: Better customer services can ensure better relationship between a banker and a customer. Logically, customers can claim some services as debtors, creditors, buyers and some as fellow Muslim brothers and still some more as fellow men in general. Islam is well known as a complete code of life, based essentially on the many verses of the holy Quran and many sayings of the Prophet (peace be upon him). So it is the duty of an Islamic Bank to satisfy the needs of the above parties.

Legal Reformation: To give the legal shape to the banker-customer relationship in Islam, some existing conventional banking laws and related laws need to be changed according to Islamic Shariah. In Pakistan, 13 (thirteen) existing laws have been changed to Islamize its banking system.

Charity Functions: The resources of a conventional bank are used for the purposes and activities having high social priority but for commercially viable projects only. These banks have no operations designed for charity-based projects. So, the conventional bankers have limited relationships with their customers.

6.6 Termination of Banker-Customer Relationship

As the banker-customer relationship can be established, so it can also be terminated. It arises between a banker and a customer with the opening of an account by the customer with a banker. So, the relationship terminates if the account is closed for any reason.

Banker-customer relationship may be terminated due to the following reasons:

i) If a banker does not pay the check of a customer, which has been drawn duly on his account, not withstanding the availability of deposited money in the account;

ii) If the secrecy of the customer's account is not maintained legally and morally by the banker;

iii) If the banker does not provide banking services to the customer properly. For example, if checks, bills etc. are not collected without informing the customer;

vi) If the banker does not supply Pass Book or Statement of Account to the customer;

v) If any fraudulent check comes to the hand of a banker and if he makes payment without informing the customer). If the banker makes any charge on transactions which is not permissible in Islamic Shariah. For example, if interest is charged or a bribe is alleged;

vi) If the banker fraudulently embezzles the customer's money;

vii) If the customer diverts the investment into the business which is not permissible in the Shariah;

viii) If the customer shows unwillingness to pay Zakat on the deposited money with the bank, even though he is a Muslim;

ix) If the customer defaults on a loan; and

x) If any agreement is otherwise violated either by the banker or by the customer.

CHAPTER SEVEN

FINDINGS, RECOMMENDATIONS AND CONCLUSION

7.1 Findings

Bank is a financial institution. The service of a bank is considered as its product and activities Bank Is financial intermediary dealing in accepting surplus savings as deposits and extending funds to those who can approach the bank with bankable projects. Amount of funds can be increased or decreased depending on the professional skill of the bank executives. Efficiency of customer service is related with progression of operation. Islami Banking operations are increasing gradually. Each year deposits and investment growth indicates Islami Banking better movement in the banking field, which is satisfying clients. As a result , clients are increasing and ultimately equity is increasing. Gradually bank’s o operation is increasing. Investment is rising rapidly and a good response is getting from the clients is different investment scheme. Islami Banking rising movement is generating increasing profit. Client’s satisfaction depends on the efficacy of customer service. All operational improvement with profit leads us to say that value of customer service of Islami Banking is in the positive situation.

7.2 Recommendations

Though Islami Banking is performing well but it has some crucial areas to improve which are prescribed below:

1. It is a modern banking era now. Each and every commercial bank is properly utilizing technological innovations. So, Islami Banking needs to utilize these modern technologies to keep pace with the modern time.

2. Islami Banking needs to recruit skilled human resources which can turn the bank ahead.

3. The bank should offer facilities such as Credit card, Visa card and all alternative delivery channels

4. Islami Banking investment processing should become easier than other conventional banks.

5. Islami Banking should make its investment schemes more attractive for availing high-return projects.

6. Islami Banking should consider utilization of rural potentials from both efficiency and equity grounds in the context of the present-day socio-economic conditions of Bangladesh. Strong commitments and stepping up through experiment and implementation of innovative ideas are the appropriate ways to do that.

7.3 Conclusion

Islam is a complete way of life and Allah's guidance extents into all areas of our lives. Islam has given detail regulations for our economic life. Therefore, Islami Banking is trying to establish the maximum welfare of the society by maintaining the principles of Islamic Shariah which is based on "Quran" and "Sunnah". Since 1983, Islami Banking is the pioneer in welfare banking in this subcontinent and it is trying to do all its activities for the betterment of its depositors. For the greater interest of the depositors the investment policy of Islami Banking are to invest on the basis of profit and loss sharing in accordance with the tents and principles of Islamic Shariah. Profit earning is not the only motive and objective of the bank's investment policy rather emphasis is given in attaining social good and in creation employment opportunities. Islami Banking is not secular in its orientation. Islami Banking does not finance any project which conflicts with the moral value system of Islam. Islami Banking does not strictly consider the credit worthiness of the entrepreneur. Islami Banking receives a return only if the project succeeds and produces a profit. Islami Banking considers the soundness of the project and business acumen and managerial competency of the entrepreneur. Therefore, the rate of return of investment of Islami Banking is greater comparing to that of conventional banks.

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