BankIslami

INTRODUCTION TO
ISLAMIC BANKING
WITH
BankIslami

I am Saving Humanity From Riba

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INTRODUCTION TO **ISLAMIC BANKING** WITH BankIslami

Presented by

Shariah Department, BankIslami Pakistan Limited

This booklet is authored by the Shariah Department of BankIslami Pakistan Limited. The purpose of preparing this booklet is to increase awareness about Islamic Banking amongst the public. Although this booklet has been reviewed in detail, kindly inform us on following email address regarding any improvement / rectification so that the correction can be made in the next edition:

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Foreword

بسم الله الرحمن الرحيم

الحمدُ للهِ ربِّ العالمينَ، والصَّلاةُ والسَّلامُ على أشرفِ الأنبيَاء والمُرسلينَ،
وعلى آلهِ وأصحابِه أجمَعينَ، وبعدُ

Our religion, Islam, is a comprehensive and complete religion which means that it provides guidelines pertaining to every aspect of life. These guidelines, in addition to the acts of worship (*Ibadaat*), also encompass other areas of life which include beliefs (*Aqai'd*), financial dealings (*Muamlaat*), social relationships (*Muaashrat*) and moral characters (*Ikhlaqiyat*). It is an important requirement of Islam to follow all these guidelines in entirety to become an ideal Muslim. Islam also gives a comprehensive framework on economic and financial matters which are among the significant aspects of life. In current times, Islamic banking, as a Shariah compliant alternative of conventional banking, ensures that banking services are being offered in compliance with the dictates of Islam.

BankIslami Pakistan Limited is one of the leading financial institutions offering Islamic banking services. As a mission-driven bank, BankIslami aims at spreading awareness of Islamic banking concepts amongst the public. This booklet titled "Introduction to Islamic Banking, with BankIslami" is a part of these efforts. The booklet addresses topics such as general services offered by a bank, need of Islamic banking, difference between Islamic and conventional banking, products offered by Islamic banks and answers to frequently asked questions.

I hope this effort will be beneficial in increasing the awareness of basic concepts of Islamic banking. The readers are requested to share their valuable suggestions and recommendations as they will play an important part in making this endeavor fruitful and assist us in making improvements in the next edition.

May Allah Subhana wa Ta'ala accept this effort and make it beneficial and helpful in saving humanity from Riba.

Mufti Irshad Ahmad Aijaz
Chairman, Shariah Board
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Islam: A complete code of life

The guidelines of Islam are not only limited to acts of worship (*Ibadaat*) but they also cover other aspects of life which include beliefs (*Aqai'd*), financial dealings (*Muamlaat*), social relationships (*Muaashrat*) and moral character (*Ikhlaqiyat*). Accordingly, Islam requires Muslims to adopt its teachings in a holistic manner encompassing both their individual and communal spheres of life. In this booklet, we will discuss guidelines pertaining to banking and financial dealings as Islam stresses upon the correctness and sanctity of financial dealings. Therefore, as Muslims, it is imperative for us to have a basic understanding about this aspect of our faith.

Islamic banking was introduced with the purpose of offering banking services without the element of interest and other prohibitions in Islam. In Islamic banking, it is ensured that the deposits are received and financing is offered in a Shariah compliant manner thereby making it a Shariah compliant alternative of conventional banking.

Importance of financial dealings

As Muslims, it is our responsibility that, in addition to practicing other aspects of our faith, we follow the guidelines of Islam in our financial dealings as well. Negligence in financial dealings also negatively impacts the acceptance of other acts of worship (*Ibadaat*). As per a Hadith, any charity (*sadqa*) given from impermissible (*haram*) earnings is not accepted (Sunun Nasai, Hadith no. 2526). According to another Hadith, supplication (*dua*) of that person is not accepted who consumes from impermissible (*haram)* earnings (Sahih Muslim, Hadith no. 2346). It is evident from these narrations that earning in a permissible (*halal*) manner plays a crucial role in the acceptance of supplications.

The real success of a Muslim is success in the hereafter (*Akhirat*). In fact, it is the fear of accountability in the hereafter that distinguishes a Muslim from other human beings. According to a Hadith, a person would not be allowed to move from his/her position on the Day of Judgment until he/she has been asked five questions – two of which pertain to earnings and expenditures i.e. what was the source of earnings and where was it spent? (Sunan Darami, Hadith no. 556). Therefore, only a cautious approach in earnings and expenditures can save a Muslim from punishment in the hereafter.

For this purpose, we need to ask ourselves what are the requirements that Shariah expects us to fulfill while entering into financial dealings? If we are not aware of them then let us start! This booklet will not only teach us some of the basic rulings of Islam regarding financial dealings but also address questions like how Islamic banks are fulfilling the financial needs of customers within the ambit of Shariah? What are the products offered by Islamic banks?

Before moving on to the detailed guidelines of Islam for financial dealings, let us first review the activities of a conventional bank.

Bank

We deal with a bank to perform different tasks such as utility bills payment, deposit and encashment of cheques, etc. but fundamentally, a bank is an institution that accepts deposits in the form of different accounts and fulfills financial needs by extending financing facilities.

Need and importance of a bank

We can understand the need and importance of banks by noticing their impact on commercial activities. For instance, it can be observed that business activity is generally higher on the days the banks are open whereas on the days they are closed, a decrease in the volume of business activity is quite evident. This shows that banking is a vital cog in the functioning of modern economy. Its importance and need is further emphasized through the following points:

1. Security of funds

We usually do not consider keeping large amount of cash at home as it can be stolen but if it is deposited in a bank, we consider it to be secure. Banks provide the facility of Current Accounts which make sure that the cash remains protected while giving an option to the account holders to withdraw the cash whenever required.

2. Investment

Most of us spend our earnings with prudence so that we can save some amount in case any urgent requirement arises in future. If such savings are kept at home, we can neither earn any profit on it nor can we avoid the erosion of their value due to inflation. For this purpose, banks offer Saving Accounts and Term Deposits as effective tools of investment to earn a suitable profit.

3. Facility to fulfill financial needs of customers

Most of us require funds to purchase car, house, home appliances, etc. Banks offer different financing facilities to fulfill these needs.

4. Providing funds required for running business

To run a business, sometimes short term funding is required to purchase raw material (for manufacturing purposes), payment of salaries, utility bills, etc. In some cases, financing is required for a longer term e.g. to construct a factory or to acquire machinery. Banks cater to all these business needs.

In addition to the above-mentioned services, banks also provide a number of other services.

The different array of services offered by the bank play a vital role in today's society. Therefore, even if an institution offering these services is not called a 'bank', there will still be a need for the provision of these services that have become a necessity in the modern day and age. From an Islamic perspective, of course, these services are required to be provided in a Shariah compliant manner.

> The services offered by a bank have become indispensable today in order to cater to the needs of the contemporary economic world and complex financial needs. Islamic banking was introduced to offer these services in a Shariah compliant manner.

Need for Islamic banking

A fundamental question now arises about the reason of existence of Islamic banking i.e. when a banking system already exists then why suggest a new mechanism? We have addressed this earlier that, while it is a reality that banking has become a fundamental need for the society, its business structure is based on the concept of borrowing and lending. Conventional banks fulfill the financial needs of customers by earning and paying additional amounts on loans (*qard*) which is tantamount to interest. On the other hand, when we study Islamic teachings we realize that earning any additional amount on loan (*qard*) has been clearly prohibited by Allah Subhana wa Ta'ala in the Holy Quran. This implies that it is not permissible from the Shariah perspective to fulfill the banking needs by borrowing and lending on interest (*riba*). This leads to the need for Islamic banking so that the banking services can be offered on the basis of Shariah principles.

Interest - The reason for prohibition of conventional banking

Financial dealings should be free from the element of interest, also referred to as '*Riba*' in Arabic language with a literal meaning of 'addition' or 'increase'. When we search for the meaning of interest (*riba*) in Shariah, we come across a quote by Hazrat Ali (*RadiAllahu anhu*) which is as follows:" كُلُّ قَرْضٍ جَرَّ مَنْفَعَةً فَهُوَ رِبًا " (Al Matalib Al Aalia, Hadith no. 1440) and it is translated as "Any such loan that brings a benefit on it (i.e. any additional amount received on it) is interest (*riba*)".

It is evident from this quote that any addition on all types of loan will be termed as interest (*riba*) i.e. whether the loan has been taken for commercial/business purposes or for personal financial needs and whether the addition/gain has been received in cash or in the form of any other benefit. Even if this addition/gain is termed differently, e.g. mark-up or profit, it is important to remember that if the transaction is based on a loan (*qard*), any agreed addition/gain on the loan would be interest (*riba*).

Clearing a Misconception

Many people think that the amounts deposited with a conventional bank are not on a loan (*qard*) basis but on a trust (*amanat*) basis; therefore, in the absence of loan arrangement, the matter of interest (*riba*) does not arise. It needs to be understood that this is a loan arrangement from Shariah perspective as the bank guarantees the deposited funds and uses the funds in its business activities both of which are characteristics of a loan (*qard*). From Shariah perspective, funds received on the basis of trust (*amanat*) are not allowed to be used and are required to be returned in the same condition as they were received. Additionally, trust funds (*amanat*) cannot be guaranteed and are not bound to be compensated if lost without any negligence.

Prohibition of interest (riba) in the light of Holy Quran

Interest (*riba*) has been mentioned on four occasions by Allah Subhana wa Ta'ala in the Holy Quran:

1. Verse no. 275 – 281, Surah Al Baqarah
2. Verse no. 130, Surah Aal e Imran
3. Verse no. 161, Surah An Nisa
4. Verse no. 39, Surah Ar Roum

A summary of the teaching of these verses is as follows:

- Apparently interest (*riba*) increases wealth but it does not increase in the view of Allah Subhana wa Ta'ala. This connotes that there is no barakah in interest earning.
- Interest (*riba*) and profit earned through trading appear to be the same but Allah Subhana wa Ta'ala has permitted trade and disallowed interest ***(riba)***. This reflects that resemblance of result may associate two matters to be similar in Shariah status but it is the process that defines it.

- Allah Subhana wa Ta'ala increases charity (*sadaqaat*) and decreases interest (*riba*).
- There is a declaration of war by Allah Subhana wa Ta'ala and Prophet Muhammad ﷺ against those who do not give up on interest (*riba*).

Prohibition of interest (riba) in the light of Ahadith

Interest (*riba*) has been disallowed and admonished severely in Ahadith. Some of these Ahadith are as follows:

- Prophet Muhammad ﷺ has cursed upon the receiver of interest (*riba*), payer of interest (*riba*), the witnesses and the recorder of the interest (*riba*) based transaction and mentioned that all are equal in the sin. (Hadith no. 1598, Muslim)
- The evil of interest (*riba*) has been described in such a manner that interest (*riba*) has seventy degrees and the least degree of it is equivalent to a person committing adultery with one's own mother. (Hadith no. 2274, Sunan Ibn e Maaja)

One of the wisdoms behind the impermissibility of interest (*riba*) is that it prevents actual economic activities. If one were allowed the option to earn a profit simply by lending, why would that person want to bear the risk of investing in actual real economic activities? This, in turn, affects the economic welfare of the society that can be ensured only through real economic activities. (Imam Ghazali Rahmatullah Alaih)

It is clear that the element of interest (*riba*) is present in conventional banking and the need of Islamic banking is evident. In the following segment, we will learn how Islamic banks function.

Islamic bank

An Islamic bank is an institution which provides banking services i.e. accepting deposits, providing financing facilities, etc. in compliance with Shariah principles.

Characteristics of an Islamic bank

Following are the characteristics of an Islamic bank:

- Ensures all transactions are Shariah compliant i.e. the transactions are free from the elements of interest (*riba*) as well as other prohibitions in Shariah such as *Gharar* (excessive uncertainty), *Qimar* (Gambling), etc.
- Ensures to receive deposits and extend financing facilities in compliance with Shariah principles.
- Provides facilities for Shariah compliant businesses only.

Main Differences in Islamic and conventional banking

Following are some of the main differences in Islamic and conventional banking:

	Islamic bank	Conventional bank
Basis	All Islamic banking activities comply with Shariah principles.	Major activities of conventional bank are Shariah non-compliant.
Deposits Structure	Islamic banks accept saving deposits on the basis of Mudarabah (profit and loss sharing basis).	Conventional banks accept saving deposits on loan (*qard*) basis which results in interest (*riba*).
Customer	Islamic banks do not deal with customers whose core business activity is completely Shariah non-compliant.	Conventional banks can deal with such customers whose core business activity is completely Shariah non-compliant.
Modes of Financing	Islamic banks provide financing facilities on the basis of Shariah compliant contracts such as Shirkat (Partnership), Sale/Purchase, Ijarah (Rent), etc.	Conventional banks extend financing facilities through interest (*riba*) based loans which is prohibited in Shariah.
Shariah Governance System	All financial dealings of an Islamic bank are governed through a comprehensive 'Shariah Governance System'.	In the absence of a Shariah Governance System, there is no mechanism of a Shariah based supervision of the financial dealings of a conventional bank.

Islamic Banking Model

Banking activities can be categorized as:

1. Deposit side
2. Financing (Asset) side

Conventional Banking	
Deposit Side	Asset Side
Loan (*qard*)	Loan (*qard*)

Let us now understand how an Islamic bank ensures that these two activities are in compliance with Shariah principles!

Islamic Banking

Deposit Side
- Mudarabah
- Non-interest based loan

Asset Side
- Partnership
- Lease/Rent
- Trade

In Islam, a loan (*qard*) is a non-remunerative contract i.e. it can only be interest-free which is why it cannot form the basis of a business transaction. Therefore, to earn a profit, it is important to use contracts in which remuneration is permissible in Shariah such as Partnership (*Shirkat*), Lease (Rent), Trade, etc. The use of such contracts is what primarily distinguishes Islamic banking from conventional banking.

1. Deposit side

Islamic banks accept Current Account deposits on the basis of non-interest based loan (*qard*). Whereas the Saving and Term deposits are accepted on the basis of Mudarabah which are invested in Shariah compliant businesses/activities on profit and loss sharing basis.

2. Asset side

Islamic banks provide financing facilities to customers through different Shariah compliant modes/products that include Murabahah, Salam, Istisna, Diminishing Musharakah, etc. Details of these Shariah compliant modes/products will be discussed ahead.

Basis of Deposits in Islamic banking

Qard (Loan)

This is a transaction in which a thing of value (often money) is given by a lender to borrower for their use. The loan is to be repaid by the borrower on demand of the lender.

It is permissible in Shariah to give a loan. However, it is not allowed to receive any additional gain/benefit on it as it is tantamount to interest (*riba*) which is impermissible (*haram*).

In Islamic banks, Current accounts are generally opened on loan (*qard*) basis as the purpose of such accounts is not to earn any profit but to keep the funds secure and guaranteed. As customers do not assume any risk on such funds, they are not entitled to earn any profit on it. Moreover, in line with the Shariah requirements pertaining to loan (*qard*), the bank ensures that customers receive deposited amounts on demand.

Mudarabah

Mudarabah is a partnership in which one partner invests funds while the other partner manages the work. The profit earned is distributed between them as per a pre-agreed profit sharing ratio. The Investing Partner and Managing/Working Partner are referred to as "*Rabb-ul-Maal*" and "*Mudarib*" respectively.

In Saving and Term deposits, an Islamic bank works in the capacity of Working Partner (*Mudarib*) whereas the depositors are Investing Partners (*Rabb-ul-Maal*). After receiving the deposits on Mudarabah basis, Islamic banks invest them across various Shariah compliant avenues e.g. rental arrangements, commercial partnerships, trading, investments, etc. to earn profit.

Rules of Mudarabah

Following are some of the important rules to be followed in a Mudarabah arrangement:

- The partners must agree upon the profit sharing ratio at the time of entering into Mudarabah.
- The Investing Partner (*Rabb-ul-Maal*) and Working Partner (*Mudarib*) cannot pre-agree a fixed profit amount.
- Profit amount cannot be linked to the investment amount e.g., it is impermissible to agree that profit will be received as 10% of Rs. 100,000 (capital invested).
- In case of Loss, the Investing Partner (Rabb-ul-Maal) will bear it completely while the Working Partner (*Mudarib*) will not earn any profit for rendered services. However, if the loss incurred is due to negligence of Working Partner (*Mudarib*), it will have to be borne by Working Partner (*Mudarib*).

Mudarabah with Bank's depositors

Normally in a Mudarabah, there is one Working Partner (*Mudarib*) and one Investing Partner (*Rabb-ul-Maal*). In Mudarabah with an Islamic bank, however, all the depositors (of Saving and Term deposits) are collectively the Investing Partner (*Rabb-ul-Maal*) and the Islamic bank is the Working Partner (*Mudarib*). Record keeping of all depositors' investments (considering that they are allowed to invest and withdraw funds frequently) and subsequent profit and loss distribution separately with each depositor is a strenous activity. Hence, to make this activity easier and practical to execute, a mechanism has been designed under the guidance of Shariah Scholars which is discussed ahead.

Procedure of Mudarabah in Islamic banks

The duration of Mudarabah is set as one month with renewal at the end of every month. At least three working days prior to the start of every month, the profit sharing ratio between the bank and the depositors as well as the weightages between the depositors in the Deposit Pool are decided and announced. These profit sharing ratio and weightages are published on the bank's website and notice board of the bank's branches.

The term 'Pool' in Islamic banks normally refers to a notional pool of funds formed through deposits. 'Weightages' are used to differentiate between the depositors based on the difference in their deposit amounts and tenures. For example, a depositor investing funds, on Mudarabah basis, with the bank for 5 years can be assigned a higher weightage (entitling him/her to earn higher profit) as compared to a depositor who is investing funds for 3 years.

Upon the end of the month, the profit earned from banking operations is divided between the bank and Pool as per the pre-agreed profit sharing ratio. After this exercise, the profit earned by the Pool is distributed by the bank amongst the depositors as per the weightages on Monthly Average Balance basis.

An expected rate of profit can be quoted on the deposits received under Mudarabah i.e. remunerative deposits, but this profit rate cannot be guaranteed. The profit is distributed on the basis of pre-agreed profit sharing ratio and weightages. At the end of the Mudarabah term, if the bank earns a profit, each partner is entitled to a share in it as per the pre-agreed profit sharing ratio and weightages. This actual profit earned may be less or more than the expected profit rate quoted beforehand.

Modes of Financing in Islamic banking

Partnership (Shirkat)

In Islamic jurisprudence (*fiqh*), the term '*Shirkat*' is used for Musharakah, which means to enter into a partnership. There are two types of Shirkat:

1. **Shirkat-ul-Milk (Co-ownership of asset):**

   This means co-ownership of two or more persons in an asset without a commercial intention e.g. heirs getting ownership of inherited assets of their father, two persons jointly purchasing a property for own use, etc.

2. **Shirkat-ul-Aqd (Partnership in business):**

   This means partnership of two or more persons in a commercial enterprise. In such a partnership, the profit earned is shared as per a pre-agreed profit sharing ratio, whereas, any loss incurred is shared as per investment ratio.

Rules of Shirkat-ul-Milk

Following are some of the important rules of Shirkat-ul-Milk:

- One of the partners can rent their share to a third party with the consent of the other partner.
- The co-owners/partners share the risk and reward of the owned asset as per their ownership ratio.

Rules of Shirkat-ul-Aqd

Following are some of the important rules of Shirkat-ul-Aqd:

- Profit sharing ratio needs to be agreed at the time of entering into the partnership.
- Profit amount for any partner cannot be pre-agreed. It also cannot be linked to the investment amount e.g., it is impermissible to agree that profit will be received as 10% of Rs. 100,000 (capital invested).
- Loss will always be borne by the partners as per their investment ratio. However, if the loss is incurred due to the negligence of a partner, then the loss will be borne by that partner.
- In principle, all partners have a right of working for the business. However, the partners can agree that a partner will not work/be involved in the management. In such case, the profit sharing ratio of that partner cannot be higher than his/her capital investment ratio.

Currently, Islamic banks offer the following two financing products based on Musharakah:

1. Diminishing Musharakah (based on Shirkat-Milk)
2. Running Musharakah (based on Shirkat-ul-Aqd)

Diminishing Musharakah

Diminishing Musharakah is generally offered on the basis of Shirkat-ul-Milk. Following are the three legs of a Diminishing Musharakah transaction:

1. **Shirkat-ul-Milk (Partnership):**

   In the first leg, the bank and customer jointly purchase an asset and become co-owners that establishes their joint ownership in that asset.

2. **Ijarah (Lease):**

   The bank rents out its share in the asset for use to the customer against agreed rentals.

3. **Sale of ownership share:**

   The bank, from time to time, sells its ownership share in the asset to the customer. Over the period, the customer's share in the asset increases and accordingly the bank's share decreases. Upon purchase of entire bank's share, the customer becomes the sole owner of the asset.

Application of Diminishing Musharakah

Diminishing Musharakah is widely used as a mode for long term financing to fulfill different needs of the customers such as house financing, auto financing, project financing, acquisition of capital assets, etc.

Running Musharakah

Another way of offering financing facility on Musharakah basis is Running Musharakah. This is a Shariah compliant alternative of the conventional Running Finance facility. Running Musharakah is offered on the basis of Shirkat-ul-Aqd in which the bank becomes a partner in the business operations of the customer on profit and loss sharing basis.

Following are some key features of Running Musharakah:

- The bank becomes a partner in the core business operations of the customer.
- The funds provided by the bank to the customer are an investment of bank in the business of the customer.
- The funds paid back by the customer to the bank reflect a decrease of bank's investment share in the business of customer along with withdrawal of provisional profit.
- The profit sharing ratio is normally set according to the respective ratios of investment.
- Upon availability of the audited financial accounts of the customer, the profit and loss calculations of the Running Musharakah are finalized and provisional profits are adjusted accordingly.
- In case of loss in Musharakah, loss is shared as per the investment ratio.

Application of Running Musharakah

Running Musharakah is offered by Islamic banks as a way of providing running finance facility to the customers in a Shariah compliant manner.

Rental/Lease Arrangement

Ijarah

Ijarah means rental/lease arrangement i.e. to give something for use against rentals. In Ijarah, the person renting out (lessor) remains the owner of the asset, whereas, the other person (lessee) uses the asset. The ownership related risks and expenses remain responsibility of the lessor whereas the usage related expenses are borne by the lessee.

Rules of Ijarah

Following are some of the important rules of Ijarah:

- Ijarah contract can only be entered into for assets that remain useable. Assets that are consumed upon their usage e.g. petrol, gas, etc. cannot be made subject matter of Ijarah.
- The description and specification of Ijarah asset must be clearly known at the time of entering into Ijarah.
- The tenure and rental amounts of Ijarah must be mutually agreed by the contracting parties.
- The ownership related risks and expenses shall remain responsibility of the lessor.
- The usage related expenses shall be borne by the lessee.

Application of Ijarah

Ijarah is a commonly used mode for long-term financing. Auto financing, plant and machinery acquisition financing, etc. are commonly offered on Ijarah basis by Islamic banks.

Trade

Islamic banks provide financing on sale/purchase basis mainly through the following four methods:

1. Murabahah

Murabahah is a sale transaction in which the seller discloses the cost of goods to the buyer.

Musawamah

Musawamah is a sale transaction in which the seller only discloses the total price of goods i.e. the cost and profit break-up is not disclosed to the buyer.

Rules of Murabahah and Musawamah

Following are some of the important rules of Murabahah/Musawamah:

- The goods must exist and be under the ownership and possession (whether physical or constructive) of the seller at the time of entering into a sale transaction.
- The payment terms of the sold goods must be mutually agreed and can be on advance, spot or credit/installment basis.

Application of Murabahah and Musawamah

Islamic banks offer financing based on Murabahah in cases where the customers require funds to purchase goods, that can be raw material or finished goods.

2. Tijarah

In certain cases, customers have finished goods available with them for onward sale in the market on a credit basis. If such customers require financing, bank purchases the finished goods from them at a discount on cash basis. The bank then appoints the customer as its agent to sell the goods in the market at a profit. This way of providing financing facility to customers is generally termed as 'Tijarah financing'.

Rules of Tijarah

Following are some of the important rules of a Tijarah transaction:

- The goods shall be in existence, identified and under the ownership of the seller at the time of sale.
- The goods shall be under physical or constructive possession of the seller at the time of sale.
- The price of the sold goods must be mutually agreed.

Application of Tijarah

Tijarah Financing is offered in cases where the customer has finished goods available for onwards sale and requires liquidity to meet the running expenses of its business.

3. Salam

Salam is a sale transaction in which the complete sale price is paid in advance by the buyer whereas the commodity is to be provided by the seller on agreed future date. Such sale transactions are permissible in Shariah under certain conditions. Even though the general rules of a sale transaction (i.e. the existence of commodity and the commodity being in ownership/possession of the seller) are not met at the time of entering into a Salam transaction, it has been allowed as an exception to these rules in the light of Ahadith.

Rules of Salam

Following are some of the important rules of a Salam transaction:

- Salam is only allowed for commodities which are homogeneous and fungible in nature i.e. every unit of the commodity should be identical and substitutable in nature e.g. sugar, rice, wheat, etc.
- The commodities shall be completely specified i.e. type, quantity, etc. and the price and other important terms shall be agreed at the time of entering into Salam in such a manner that no ambiguity remains.
- It is important to agree upon the delivery date and the delivery place at the time of entering into Salam transaction.

Application of Salam

Financing is offered under Salam in cases where the customer can supply certain commodity (which fulfills Salam conditions) to the bank on a future date and requires liquidity to meet the running expenses of its business.

Upon receipt of possession of the commodity, the bank generally appoints the customer as its agent to sell the commodity in the market at a profit.

4. Istisna

Istisna is a sale transaction in which the subject matter is an asset that requires manufacturing. Generally, the buyer gives an order to the seller and the seller manufactures the asset keeping in view the buyer's requirements. The payment terms can be mutually agreed to be advance, cash, credit or on instalment basis. The asset is manufactured and delivered to the buyer at a later date. In Istisna as well, even though the general rules of a sale transaction (i.e. the existence of asset and the asset being in ownership/possession of the seller) are not met at the time of entering into Istisna contract, it is permissible in Shariah, subject to certain conditions. Therefore, it has been allowed as another exception to these rules in the light of Ahadith.

Rules of Istisna

Following are some of the important rules of an Istisna transaction:

- The asset to be manufactured shall be specified at the time of entering into Istisna contract in an unambiguous manner.
- If the manufactured asset is not as per agreed specifications, the buyer has the right to return the asset.
- Price and payment terms shall be mutually agreed upon.
- The raw material required for manufacturing shall not be provided by the buyer i.e. the seller shall use its own raw material.

Application of Istisna

Financing is offered under Istisna in cases where the customer can manufacture/deliver certain assets (which fulfill Istisna conditions) to the bank on a future date and requires liquidity to meet the running expenses of its business.

Upon receipt of possession of the manufactured asset, the bank generally appoints the customer as its agent to sell the asset in the market at a profit.

Frequently Asked Questions regarding Islamic Banking

Is there any concept of banking in Islam?

Indeed, yes. If an institution receives funds under a Shariah compliant arrangement and invests those funds in a Shariah compliant manner in commercial transactions to earn profit, and if such an institution is termed as a 'bank' then the concept of such an institution definitely exists in Islam. However, if a bank deals in interest based transactions, there is obviously no such concept in Islam. In the early years of Islam, we have the example of a famous companion, Hazrat Zubair bin Awam (*RadiAllahu anhu*) with whom people wished to deposit their money on a trust basis (*amanah*) due to his trustworthiness. He used to refuse to accept funds on trust (*amanah*) basis; however, he agreed to accept funds as loan (*qard*) and would then invest those funds in trading activities. This practice of Hazrat Zubair (*RadiAllahu anhu*) of receiving funds and then investing onwards in trade activities is quite similar to the practice of the banks today (Page no. 68, 'A Historic Judgment on Riba' by Mufti Muhammad Taqi Usmani).

Does an Islamic bank deal in interest (*riba*) with State Bank of Pakistan?

No. The State Bank of Pakistan has two different relationships with Islamic banks. Firstly, the State Bank of Pakistan, in the capacity of a regulator, issues instructions over time that are generally of an administrative nature e.g. providing instructions on improving customer service, etc. Secondly, at times the Islamic banks and State Bank of Pakistan enter into financial transactions. In such cases, it is always ensured that the financial transactions comply with Shariah principles.

Islamic banking and conventional banking apparently look the same. Is Islamic banking not the same as conventional banking except for different terminologies?

Not at all. It is not necessary that if the end result of two different processes is the same then the same Shariah ruling will be applicable on both. We come across different examples of this in daily life. For example, one animal can be slaughtered with the name of Allah Subhana wa Ta'ala and the other without His name. After being slaughtered, meat of both animals will appear to be the same. But the meat of one animal will be considered permissible (*halal*) and the other as impermissible (*haram*) considering the difference in the process of slaughtering between the two.

Similarly, it will be incorrect to say that since an Islamic bank earns the same as a conventional bank, therefore, there is no difference between the two. For instance, if a person is selling juice and another person is selling alcohol and the profit amount earned by both is the same, then just because of the same profit amount, the earnings of the juice seller cannot be considered impermissible. Also, consider a situation where a person is hungry. In order to satisfy his/her hunger, that person can either earn through lawful means or commit a robbery. In both cases, the hunger will be satisfied i.e. the end result will be same but one process will be considered permissible and the other impermissible. Therefore, a Shariah ruling cannot be given just on the basis of the end result; in fact, the whole process, along with the terms and conditions agreed between the parties, will have to be looked into before arriving on an opinion.

Conventional banks receive penalty from customers in case of delay in payments. Islamic banks also receive an additional amount as charity from customers in case of delays. Is this additional amount also not interest (*riba*)?

The additional amount received by the conventional banks as penalty from the customers on delayed payments is interest (*riba*) as the underlying contract in conventional banking is of loan (*qard*). Such penalty also becomes part of the income of the conventional banks.

Whereas, the additional amount received by the Islamic banks is a Charity amount which customers, at the time of entering into the financing transaction, promise to give in charity, upon demand of the bank, in case there is a delay in payments by the customers. Such Charity amount does not form part of income of the Islamic bank and is distributed to charitable institutions, on behalf of the customers. This arrangement is used to discourage customers from delaying their payments and is permissible in Shariah. The Islamic banks give complete disclosure about the Charity amount received and the amount distributed during the year in their annual audited accounts.

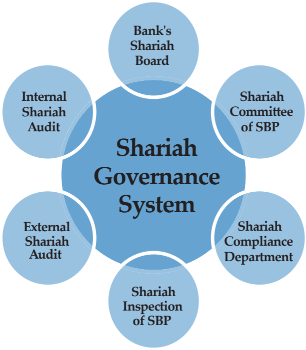
Is it right for Islamic banks to use an interest rate benchmark e.g. KIBOR in their financing transactions?

The question itself mentions that KIBOR is a benchmark which simply means a standard to gauge something or the market rate e.g. in the Karachi gold market, a standard market rate of gold is used as the basis for the trading of gold in the local market. Similarly, KIBOR is simply a market rate announced by State Bank of Pakistan on a daily basis for the local financial market which is used by the banks as the benchmark rate for offering financing facilities. Although KIBOR is the average rate at which the banks want to lend money to each other, this rate is not interest (*riba*) in itself. Instead, its classification as interest (*riba*) will depend upon whether or not the underlying transaction in which it is used is a loan (*qard*) based transaction. This implies that regardless of how the benchmark rate is derived, if the benchmark rate is being used to earn interest (*riba*) in a loan (*qard*) transaction, the transaction is impermissible – not because of the use of that rate but because of it generating interest (*riba*). However, if the same benchmark rate is used to determine the profit amount in a sale transaction, such profit amount is permissible because the price is being received against sale of some goods.

Let us understand this with an example. If someone were selling impermissible (*haram*) meat at a profit rate of 10%, the income earned would obviously be impermissible. However, if another seller is selling permissible (*halal*) meat at the same profit rate, his/her income cannot be called impermissible just because of using the profit rate of an impermissible transaction as a benchmark. Similarly, Islamic banks earn their profit mainly through sale, rent or partnership based transactions, while abiding by all Shariah requirements. Therefore, just by using KIBOR as a basis for profit rate in a sale transaction or rental rate in a lease transaction does not make that sale profit and lease rental impermissible.

Islamic banks are working in accordance with the principles of Shariah. How can one be sure of it?

To answer this question, one will have to understand the Shariah Governance System that is in place for the Islamic banks. The Shariah Governance System comprises of the following:



1. **Bank's Shariah Board:**
   It is mandatory for every Islamic bank to appoint a Shariah Board comprising of authentic Shariah Scholars. The Shariah Board is responsible to review and approve different products and services offered by the Islamic bank.

2. **Shariah Compliance department:**
   It is also mandatory for every Islamic bank to establish a Shariah Compliance department. This department acts as a secretariat of Shariah Board and is responsible to review the transactions, agreements, policies and procedures of the bank from a Shariah perspective. Shariah Compliance department also conducts Shariah Compliance review of the activities of other departments as well as the branches of the bank to ensure that the guidelines of Shariah Board are being properly implemented.

3. **Internal Shariah Audit:**
   Along with Internal Audit, conducting Internal Shariah Audit is also mandatory for Islamic banks. Internal Shariah Audit Unit conducts audit of the activities of the bank from Shariah perspective.

4. **External Shariah Audit:**
   Arranging External Shariah Audit of its activities is also mandatory for an Islamic bank in which a reputable audit firm conducts audit of the bank's activities from Shariah perspective.

5. **Shariah Advisory Committee of State Bank of Pakistan:**
   Shariah Advisory Committee has been established to provide Shariah advice and opinion on Shariah related matters for Islamic banking industry of Pakistan. Islamic Banking Department of State Bank of Pakistan, under the guidance of this Committee, issues different guidelines and policies for the Islamic banking industry.

6. **Islamic Banking Department of State Bank of Pakistan:**
The Department was established in the State Bank of Pakistan in 2003 to facilitate and catalyze the development of Islamic Banking in Pakistan. The department issues guidelines and instructions related to Shariah related matters of Islamic banks. The department also reviews the different products and services offered by Islamic banks and issues Islamic Banking Industry bulletin which provides an update on the overall progress of the Islamic Banking Industry.

7. **Inspection Team of State Bank of Pakistan:**
An Inspection Team of State Bank of Pakistan conducts an inspection of the activities of Islamic banks in which it is checked if the instructions issued by State Bank of Pakistan's Islamic Banking department, guidelines of Bank's own Shariah Board and other Shariah requirements are being complied by the Islamic bank.

The comprehensive Shariah Governance system, as explained above, is applicable on all Islamic banks of Pakistan and Alhamdulillah it keeps improving with time.

Conclusion

1. There is a significant difference between Islamic and conventional banking.
2. Some of the misconceptions related to Islamic banking arise due to lack of awareness.
3. The intrinsic asset/business risk has to be borne in Islamic banking unlike conventional banking.
4. The edifice of Islamic banking is based on the cornerstone of elimination of interest (*riba*) and other prohibitions in Shariah.
5. The compliance of Shariah principles in Islamic banking is not just a baseless claim. Instead, it is backed by a Shariah Governance System having solid foundations.

Our Responsibility

Now that we have understood the need and importance of Islamic banking, come and let us resolve with BankIslami that:

DEEN CONNECT

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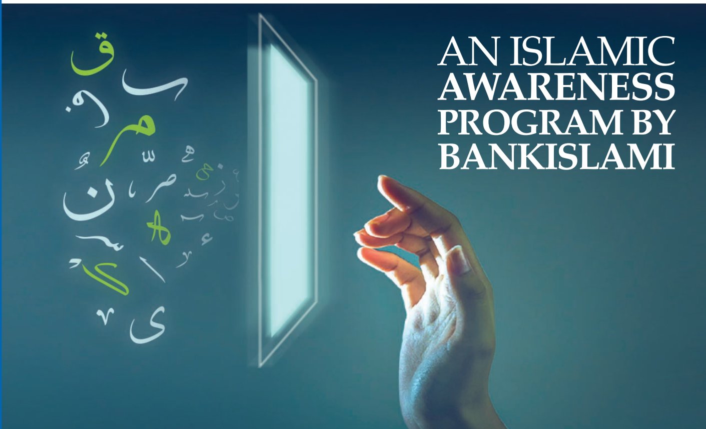

Deen Connect is an Islamic knowledge and awareness program offered **FREE OF COST** under the guidance of authentic Shariah Scholars.

Features Include:

- **Quranic Arabic Language Classes**
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