



School of Management

COMPLETE THESIS

Thesis Title: Benchmarking of Financial Solutions Offered by Islamic Banks

Supervisor: Fredrik Jörgensen

Author 1:

Name	Junaid Ahmad
Email	juaa09@student.bth.se
Registration Number	830826-P737

Author 2:

Name	Muhammad Abdul Majid
Email	maml09@student.bth.se
Registration Number	801010-T452

ACKNOWLEDGEMENTS

Firstly we are grateful to Swedish government and BTH for providing this wonderful opportunity (MBA degree) to improve our academic qualifications at no cost.

Special thanks to our supervisor Fredrik Jörgensen who has been very supportive throughout the thesis semester. Your guidance and attention enabled to improve the quality of thesis.

Last but not least we would like to thank our Programme Director Dr Marie Aurell whose so many efforts were so little appreciated.

Contents

ACKNOWLEDGEMENTS	2
1. Introduction	6
1.1 Background	6
1.2 Problem discussion.....	7
1.3 Problem formulation and purpose.....	7
1.4 De-limitations.....	8
1.5 Thesis structure	9
2. Theory.....	10
2.1 Comparison between Islamic and conventional banking.....	10
2.2 Shariah compliance in Islamic banking	12
2.3 Shariah compliance structure by SBP in Pakistan	13
2.3.1 Shariah board	13
2.3.2 Responsibilities of Shariah advisor	14
2.3.3 Essentials of Islamic modes of financing.....	14
2.3.4 Model agreements of Islamic modes of financing.....	14
2.3.5 Shariah compliance Inspection of Islamic banks	14
2.3.6 Meetings of Shariah advisors	14
2.3.7 Conflict resolution.....	14
2.4 Financial products of KFH, DIB, NBK and SCB	15
2.5 Ethics of business	16
2.5.1 Ethics of banking.....	16
2.5.2 Ethics of Islamic finance.....	16
2.5.3 Islamic banking does not deal in money	17
2.6 Risks involved in Islamic banking.....	17
2.7 Standards for verifying Shariah compliance	18
2.7.1 SBP Shariah guideline and model agreements for Islamic modes of finance	18
2.7.2 Introduction to Islamic finance, Mufti Taqi Usmani	19
2.7.3 Guide to Islamic banking, Dr. Mufti Imran Ashraf Usmani.....	20
2.8 Financial assessment of Islamic and conventional banking products	21
3. Method	22
3.1 Secondary data.....	22

3.2 Primary data.....	22
3.3 Qualitative or quantitative research	23
3.4 Research methodology	23
3.5 Research paradigm.....	24
4. Analysis.....	25
4.1 Empirical Findings.....	26
4.2 Critical Analysis of Mudaraba based saving accounts	28
4.2.1 Predetermined ratio of profit.....	29
4.2.2 Mudarib fee.....	30
4.2.3 Mudarib share rate variation (in the favor of depositor).....	31
4.2.4 Findings	32
4.3 Critical Analysis of Murabaha as an underlying mode.....	32
4.3.1 Rules of Murabaha sale.....	33
4.3.2 Factors invalidating Murabaha sale	34
4.3.3 Rules of credit Murabaha.....	35
4.3.4 Critical analysis of credit Murabaha	36
4.3.5 Murabaha for cash.....	38
4.3.6 Findings	39
4.4 Diminishing Musharaka as an underlying mode	40
4.4.1 Critical analysis of home financing under diminishing Musharaka	41
4.4.2 Promise to sell and buy.....	41
4.4.3 Buying shares in first year	41
4.4.4 Findings	41
4.5 Ijara as an underlying mode.....	42
4.5.1 Mechanism of Ijara	42
4.5.2 Valid conditions for Ijara	42
4.5.3 Agency agreement.....	44
4.5.4 Critical analysis of Ijara contract.....	44
4.5.5 Findings	47
4.6 Comparison of Islamic banks products against conventional banks products	48
4.6.1 Analysis & findings of credit cards of KFH and NBK.....	48
4.6.2 Analysis & findings of house financing of DIB and SCB.....	51

4.6.3 Analysis & findings of car financing of DIB and SCB.....	54
5. Conclusions and Implications.....	57
REFERENCES.....	60
WEBSITE REFERENCES.....	61
APPENDIX A GLOSSARY.....	62
APPENDIX B AN OVERVIEW OF ISLAMIC BANKING.....	63
1. Interest (Riba) definition.....	63
2. Explanation of Riba and its types in Islamic Shariah.....	64
3. Modes of Islamic finance.....	65
APPENDIX C SURVEY QUESTIONS.....	70
APPENDIX D INDEPTH INTERVIEW QUESTIONS.....	77

SECTION 1

INTRODUCTION

1. Introduction

Islamic banking is no doubt a growing industry in Pakistan and many Islamic countries¹⁰. State bank of Pakistan's Islamic banking department is progressing with a vision to make Islamic banking the banking of first choice for the users and providers of financial services and with a mission statement to promote and regulate Islamic banking industry in line with best international practices ensuring Shariah compliance and transparency. In Pakistan, the growth in Islamic banking industry has resulted from the highly positive response of private sector to policies for promotion of Islamic banking and finance introduced after 2001 by the State Bank of Pakistan. Collectively these factors have contributed to evolution of new and innovative products by Islamic Financial Industry in tandem with a strong and Shariah Compliant regulatory framework. According to an estimate, total Shariah compliant assets worldwide have grown to about US\$ 700 billion – with annual growth exceeding 10.0 percent during the past decade - and are projected to grow to US\$ 1.6 trillion by 2012. Other important factors are that Islamic banking is not only serving the native people but also it is attracting clients from major world economics like USA, Japan, China, France, Hong Kong. (Islamic banking bulletin SBP publication, 2010).

1.1 Background

State bank of Pakistan (SBP) has a dedicated Islamic banking department (IBD) that regulates the Islamic banking sector in Pakistan. It has a Shariah board consisting of eminent scholars that takes necessary steps to ensure Shariah compliance for Islamic banks. State bank of Pakistan has published guidelines for Islamic banks by publishing "Instructions and guidelines for Shariah compliance in Islamic banking institutions". This structure put forward by SBP for ensuring Shariah compliance in Islamic banking institutions has the following salient features²⁹:

- Shariah Board at SBP
- Shariah Advisor
- Essentials of Islamic modes of financing
- Model Agreements of Islamic Modes of Financing
- Shariah Compliance Inspection
- Meetings of Shariah Advisors
- Conflict resolution in Shariah rulings

1.2 Problem discussion

It is general perception of public^{1, 27} that financial solutions and products offered by Islamic banks are similar to conventional banks and therefore both contains the element of interest when product prices are considered. As the system is in the evolving stage so there are many factors which hinders its acceptability amongst the general public as people are confused about the Shariah (law of Islam) compliance of its products. Moreover, Islamic banks might be offering financial solutions which might not be having as attractive returns as conventional banks. So if all the principles of Islamic laws are not followed, customers may be at disadvantage and suffer loss due to some constraints in the contract.

There is immense competition in banking sector globally and specifically in Pakistan in recent years³¹. The growth of Islamic banking has created competition not only among Islamic banks but with conventional banks as well. So from customer's perspective, we need to know which banking solution is more economical and flexible. So as explained in next chapter that there are rules and regulations for each bank, we will critically analyze and compare solutions of Islamic banks against conventional banks.

1.3 Problem formulation and purpose

There are two objectives of this study. The first objective of our thesis is to perform critical analysis of financial solutions/products offered by the Islamic banks (this thesis scope limited to two specific Islamic banks mentioned later in the document) and provide benchmarking and compliance report against the Islamic principles and standards of finance found in theory i.e. are they *Shariah* compliance? (*Shariah* is an Arabic word meaning sacred law of Islam). Islam provides explicit guidelines for its followers in all areas of life and financial system is no exception. Our aim is not to criticize or promote the Islamic financial system (or conventional financial system) in this thesis. Our objective is that given the standards of Islamic financial systems, are the Islamic banks compliance with those principles. Firstly, we need to present brief introduction to Islamic financial principles and how it differs from conventional financial system. Then we need to identify the standard principles of Islamic banking which will be used to compare and analyze the products offered by Islamic banks. Our scope for standards has been restricted to three authorities in this field which are (1) Essentials and Model agreements for Islamic contracts by State Bank of Pakistan³⁰, (2) Introduction to Islamic Finance by Mufti Mohammad Taqi Usmani³⁶ and (3) Guide to Islamic Banking by Dr. Mufti Imran Ashraf Usmani^{34,35}. In all these standards, the genuine and lawful structure of Islamic models of finance have been explained i.e. these

standards highlight and emphasize the terms and conditions of ideal Islamic financial model. The solutions implemented by Islamic banks will be analyzed critically against these standards and suggestions for improvement will be presented. There are two Islamic banks which will be considered for this study which are (1) Kuwait Finance House-Kuwait and (2) Dubai Islamic Bank-Pakistan. The rationale for selecting these banks is that they are pioneer in this field and are easily accessible to authors (living in respective countries). These banks are currently offering wide variety of Islamic financial products which they claim to be Islamic.

The second objective is to compare specific products offered by Islamic banks with corresponding products of conventional banks (competitors working in same country and thus regulated by same government body). Then we will present critical analysis of both products in terms of monetary value and conditions imposed by each bank. We have chosen National Bank of Kuwait (NBK) and Standard Chartered Bank Pakistan (SCB) as conventional banks. Thus products of KFH will be analyzed against respective products of NBK and products of DIB will be analyzed against respective product of SCB.

1.4 De-limitations

As it is generally¹⁰ a wide spread fact that the Islamic banking system is in evolving stage and accordingly we do not find much work done specifically relevant to our purpose of study. Lack of availability of literature work related to this field is observed which normally lays the solid foundations of the report building. Further we can't indulge in debates and discussions of different Islamic jurists subject to the sensitivity of the matter and keeping in view the level of our own understanding of the subject and Islamic jurisprudence.

Another major limitation was that the bank management did not provide us with their confidential documents and procedures like model agreements and profit sharing mechanism that were very important for us in order to get clear picture of the financial products the bank is offering. Therefore our analysis was mainly based on the interviews that we conducted with the product development managers and the Shariah advisory committee of the banks under study. As our report was a research project and for a research an extensive pertinent data is required to come up with the refined analysis and for that we required to have an access to the official data of the bank present in documented form specially the agreements comprising the terms and conditions of the products and the contracts being undertaken between the bank and the customers but unfortunately we faced huge data constraints as the bank did not provide us any such kind of data to maintain the confidentiality except the guidance and information regarding the products and terms and conditions of the agreements and the contracts in

the form of in depth interviews with the Shariah advisor, Shariah co-coordinator and the manager product development. So the whole data extracted regarding the product information in this way is assumed to be true and based on that we tried to build and present our analysis.

1.5 Thesis structure

In the next section, we will explain the basics of Islamic banking and its differences to conventional banking, different types of interests in Islamic literature and modes of Islamic banking. In section 3, we will explain required primary and secondary sources of data in order to execute our research. In section 4, we explain how data will be analyzed. In section 5, the findings and recommendations are presented. Appendix A and B contains basic knowledge and information about Islamic banking required for this thesis. Appendix C contains brief questions as per Likert scale and appendix D contains detailed interview questions (appendix D will be optional to answer).

SECTION 2 THEORY

2. Theory

In this section, we will state the background study from literature necessary to formulate the problem. Please refer to appendix B for more information and details of Islamic banking as some basic knowledge of Finance, traditional and Islamic banking is required.

2.1 Comparison between Islamic and conventional banking

Comparison⁷ between the Islamic and Conventional financial system depicts the following main differences between the two:

Table 1: Comparison of Conventional and Islamic Banking

Conventional Banking	Islamic Banking
1. Money is priced based on the concept of time value of money in addition to the level of risk inherent in a given transaction.	1. Money is not a commodity, good or service. It has no price of its own and it cannot be used in financing or borrowing for a price, which is interest.
2. Transactions are based on financial assets.	2. Transactions are based on real assets.
3. Depositors from whom funds are borrowed are assured of a predetermined rate of interest and treated as a liability of a bank.	3. Partnership or profit and loss sharing arrangement between the Islamic bank and the investment account holders, where investment accounts are treated as quasi-equity and not debt.
4. It can charge additional money (penalty and compounded interest) in case of defaults.	4. Islamic banks have no provision to charge any extra money from the defaulters or late payers. Penalty charged is given away as charity. Rebates are given for early settlement at the Islamic bank's discretion.

5. The status of a conventional bank, in relation to its clients, is that of creditor and debtors.	5. The status of Islamic bank in relation to its clients is that of partner, investor and trader, buyer and seller, lessor and lessee.
6. A conventional bank has to guarantee all its deposits.	6. Islamic bank can only guarantee deposits for current accounts. Whereas, investment account holders based on Mudaraba, have to share losses proportionately.
7. Depositors are unaware of the bank's investment and liquidity management activities.	7. Islamic bank entitles its investment account holders to be informed of what the bank does with their money and, for some particular contracts, to have a say in where their money would be invested.
8. Most transactions involve an element of uncertainty.	8. Transactions and activities that involve uncertainty (speculation) regarding the outcome and/or timing of execution or delivery are not allowed.
9. The type of customer's business does not impose restrictions on doing business with them, as long as they are legal entities.	9. No transaction is allowed with un-Islamic businesses like brewery, casino, cigarette manufacturers etc.
10. It does not deal with Zakat (Islamic charity).	10. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a Zakat (Islamic charity) collection center and they also pay out their Zakat.
11. Lending money and getting it back with compounding interest is the fundamental function of the conventional banks	11. Participation in partnership business is the fundamental function of the Islamic banks. So we have to understand our customer's business very well.

12. It can charge additional money (penalty and compounded interest) in case of defaulters.	12. The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity. Rebates are given for early settlement at the Bank's discretion.
13. Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.	13. Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.
14. Conventional banking practices are concerned with elimination of risk.	14. Whereas Islamic bank bears the risk when involved in any transaction.

2.2 Shariah compliance in Islamic banking

Shariah compliance is the most critical aspect of Islamic banking as banking practices cannot be legitimized as Islamic unless it comply with the rules and regulations defined by the Shariah. Shariah compliance in Islamic banking is a phenomenon that ensures that the bank's underlying financial products are in accordance with the rules and laws defined by the Shariah revealed upon the last Prophet of Islam Muhammad (peace be upon him). This is explained by renowned Islamic scholar in the field of Islamic finance Mufti Mohammad Taqi Usmani³⁶, in his view the Islamic banking cannot achieve credibility unless it is based upon the firm belief in the divine guidance and injunctions revealed by God. The obedience from servants of God is required not only in worship, but also in their economic activities, even though it is at the price of some apparent benefits, because these apparent benefits may go against the collective interest of the society (Usmani, 1999).

Different countries are putting their efforts to ensure Shariah compliance of Islamic banks. Numerous regulatory organizations are instituted for this purpose like Accounting Standards for Islamic Financial Institutions (AAOIFI) that is made up of a Shariah board of 24 members consisting of eminent scholars from all over the world. In Malaysia as part of the effort to streamline and harmonize the Shariah interpretations among banks and Takaful companies, BNM (the central bank of Malaysia) established the National Shariah Advisory Council on Islamic Banking and Takaful (NSAC) on 1 May

1997 as the highest Shariah authority on Islamic banking and Takaful in Malaysia. Among NSAC's primary objectives evaluate and analyze Shariah aspects of the Islamic banks give them a careful supervision and advisory.

In Pakistan State Bank of Pakistan has taken a number of steps to ensure Shariah compliance by Islamic banks and for standardization of Shariah practices. For this purpose it has instituted a Shariah board that advises on the procedures, laws and regulations pertaining to Islamic Banking in line with Shariah principles. All the instructions guidelines pertaining to the Islamic banking Industry is issued with the approval of SBP Shariah Board. In Kuwait, Central Bank of Kuwait has also regularized services of Islamic banks and has set specific regulations.

2.3 Shariah compliance structure by SBP in Pakistan

State bank of Pakistan has a dedicated Islamic Banking Department (IBD) that regulates the Islamic banking sector in Pakistan. It has a Shariah board consisting of eminent scholars that takes necessary steps to ensure Shariah compliance for Islamic banks. State bank of Pakistan has published guidelines for Islamic banks by publishing "Instructions and guidelines for Shariah compliance in Islamic banking institutions". This structure put forward by SBP for ensuring Shariah compliance in Islamic banking institutions has the following salient features²⁹:

- Shariah Board at SBP
- Shariah Advisor
- Essentials of Islamic modes of financing
- Model Agreements of Islamic Modes of Financing
- Shariah Compliance Inspection
- Meetings of Shariah Advisors
- Conflict resolution in Shariah rulings

2.3.1 Shariah board

State bank of Pakistan has instituted a regulatory body known as Shariah board whose task is to ensure Shariah compliance in Islamic banks. It issues guidelines and instructions to fulfill this purpose. In this regard appointment of a Shariah advisor is

mandatory for every Islamic bank who acts both as a supervisor and auditor for the banks.

2.3.2 Responsibilities of Shariah advisor

Main duties and responsibilities of the Shariah advisor appointed for the Islamic bank is to ensure that all products and services and related policies and agreements of Islamic banking institutions (IBIs) are in compliance with Shariah rules and principles. The Shariah advisor prepares a report, which is published in the IBI's annual report in which he reports.

2.3.3 Essentials of Islamic modes of financing

Essentials of Islamic modes of financing entail the basic principles of Islamic modes of financing that have to be observed by Islamic banking institutions while designing their product structures, manuals policies etc. These essentials ensure compliance with minimum Shariah Standards by the Islamic banking institutions (<http://www.sbp.org.pk>)

2.3.4 Model agreements of Islamic modes of financing

Model Agreements for Islamic Modes of Financing have been introduced in order to facilitate the existing Islamic banks in developing Islamic banking products in a harmonized and legitimized manner (<http://www.sbp.org.pk>)

2.3.5 Shariah compliance Inspection of Islamic banks

SBP has developed a Shariah compliance inspection manual for Islamic banking institutions, on the basis of which regular inspections for Islamic banks are conducted. The decisions on Shariah Inspection findings help in achieving the goal of having standardized procedures for Shariah practices in the Islamic banking industry.

2.3.6 Meetings of Shariah advisors

Meetings of Shariah advisors can be called if required for the purpose of taking a Shariah opinion regarding an Islamic banking issue of mutual/collective interest. Discussions are carried out in meetings for possible resolution if so required.

2.3.7 Conflict resolution

Conflict Resolution in Shariah Rulings is also managed through the Shariah Board of SBP. In case any difference of opinion arises between Shariah Advisor of the IBI and the State Bank's Inspection staff or other SBP departments regarding Islamic Banking practices, State Bank may refer the case to SBP Shariah Board and the decision of SBP Shariah Board, notified by State Bank, shall be final.

2.4 Financial products of KFH, DIB, NBK and SCB

Dubai Islamic Bank Pakistan has more than 35 branches in 16 major cities of the country where as Kuwait Finance House has more than 70 branches in Kuwait and is pioneer of Islamic banking in the region. Both banks are offering a wide array of Islamic financing products such as Murabaha (Cost-plus sale), Ijara (Rent), Musharaka (Joint venture partnership) and Islamic Export Refinance etc., catering to a diverse cross-section of the economy, including the corporate, SME and consumer sectors. Moreover, various Shariah compliant deposit schemes are available for customers to invest their funds in, along with a variety of other ancillary services such as online banking, ATM/debit card, safe deposit lockers and utility bill payments etc. Please refer to appendix B for more information on Islamic banking products.

NBK is pioneer bank in Kuwait and has more than 70 branches locally and has presence in 13 countries across the globe. It offers state of the art banking solutions. Standard Chartered Bank of Pakistan is also a leading conventional bank with more than 150 branches nationwide and has presence in more than 50 countries. Both conventional banks offer wide range of financial solutions and services. Below table shows brief comparison (not all products mentioned below) about important products offered by all four banks.

Table 2: Overview of financial products of banks under study

Product/Service	KFH (Islamic)	DIB (Islamic)	NBK	SCB
Auto Financing	Yes	Yes	Yes	Yes
Home Financing	Yes	Yes	Yes	Yes
Saving Accounts	Yes	Yes	Yes	Yes
Credit Cards	Yes	No	Yes	Yes
Debit Cards	Yes	Yes	Yes	Yes
Business Financing	Yes	Yes	Yes	Yes
Other* Financing	Yes	No	Yes	No
Corporate Services	Yes	Yes	Yes	Yes
Insurance	Yes	Yes	Yes	Yes
Reward program	No	No	Yes	Yes
Co-brand credit cards	No	No	Yes	Yes

* Electronics goods/furniture etc

2.5 Ethics of business

Ethics is the integrity measure, which evaluates the standards and principles which constitute the base for social and individual relationships, from a moral perspective. Business Ethics (also known as corporate ethics) means trying to be a good corporate citizen; trying as an organization to adhere to certain ethical values; and trying to do the right thing by all the various stakeholders, customers, employees, suppliers and shareholders that any business organization has. It means "choosing the good over the bad, the right over the wrong, and the fair over the unfair". In a broad sense ethics in the business is simply the applications of everyday moral or ethical norms to business (George, 2005).

2.5.1 Ethics of banking

Since banks, in a modern day society, almost everywhere play an important role which includes unifying and intermediary roles between the fund-supplying and fund-demanding sides of the society, executing savings and investment functions, are obliged to obey certain ethical principles of the banking profession and organizational ethics. Simply the banking ethics are the moral or ethical principles that certain banks choose to abide by.

2.5.2 Ethics of Islamic finance

The important feature of Islamic financial system is the elimination of "Riba" or interest. Islamic finance may be viewed as a form of ethical investing, or ethical lending, except that no loans are possible unless they are interest free. Islamic Shariah has set norms and values which provide the basic framework for the conduct of economic activities in general, and financial and commercial transaction in particular. These norms include some prohibitions and some encouragements. Major prohibitions in Islamic financial system include Riba, Gharar and gambling. Some encouragements like justice, mutual help, avoiding fraud, benevolence, purification of income, proper transparency and disclosures, documentation of transactions leading to precision about the rights and liabilities of the parties and comprehensive ethics requiring care for others is also part of the Islamic framework of business norms. Giving people their due right is the cardinal principle of Islamic system of ethics.

2.5.3 Islamic banking does not deal in money

Islamic banking is a unique system of banking or banking activity that is different from the conventional banking of the world by many ways. In conventional banking system, banks get money from the public as loans and pay them interest. They give this money as advances to needy people as loans to purchase items and charge them interest. In this whole scenario the bank is not interested in the goods or items to be purchased. The main focus is of financing to purchase goods. Therefore there is famous quote about conventional banks i.e. "Banks deal in money not in document". They undertake no responsibility or risk in respect of the subject of the contracts and their counter payments or price.

While in contrast Islamic banking system instead of loaning the buyer money to purchase the goods, a bank might buy the items itself from the seller and resell it to the buyer at a profit, and allows the buyer to pay the bank in installments. However, the fact that it is profit cannot be made explicit and therefore there are no additional penalties for late payment. In order to protect itself against default, the bank asks for strict collateral. The goods or land is registered to the name of the buyer from the start of the transaction. In short Islamic banks deal in goods and documents, not in money. Many people protest and claim that interest has changed only name in case of Islamic banking system but this is not true. In Islamic banking system a real asset was sold in contrast to conventional banking where no asset was sold only money was. So it is revealed from the above discussion that Islamic banks play an intermediate role between savers/investors and fund users by involving certain goods and assets or documents representing ownership of real assets. For example in Salam or Murabaha the banks deal in certain commodities, not money. In Murabaha –sales contract if a person does not have money to buy a product, they get the bank to buy the product for them. The bank takes on the ownership and related risks and sells them at a cost plus profit margin to the person just like the traders. After sale the risk transfers to the person. The ownership of the product transfers instantly but the payment can be done latter on in installments or in total.

2.6 Risks involved in Islamic banking

In all economic activities there could be some commercial risk and one has to bear that risk for the validity of the profit or earnings. The fundamental difference between conventional and Islamic banking from the risk perspective is in the nature of risk sharing. Unlike conventional banks Islamic banks share business risks with investors and

borrowers. Islamic banks face credit/party risks, ownership transfer risks, market risks, commodity risks, price or rate of return risks, legal and documentation risks and other mode-specific risks in debt-creating modes. Islamic banks are allowed to take risk mitigation/management measures within Shariah principles. Some Islamic banks charge for the time value of money, which comes under the definition of Riba (Interest). These banks are criticized in some quarters of the Muslim community for their lack of strict adherence to Shariah. The concept of Ijara used by some Islamic Banks to apply the use of money instead of the more accepted application of supplying goods or services using money as a vehicle. A fixed fee is added to the amount of the loan that must be paid to the bank regardless if the loan generates a return on investment or not. The reasoning is that if the amount owed does not change over time, it is profit and not interest and therefore acceptable under Shariah. Islamic banks are also criticized by some for not applying the principle of Mudaraba in an acceptable manner. Where Mudaraba stresses the sharing of risk, critics point out that these banks are eager to take part in profit-sharing but they have little tolerance for risk. To some in the Muslim community, these banks may be conforming to the strict legal interpretations of Shariah but avoid recognizing the intent that made the law necessary in the first place. These controversies about Islamic banking raise the question that is Islamic banking really Islamic. And this question is still debatable in Muslim community.

2.7 Standards for verifying Shariah compliance

We are using three main sources as standard for comparing and verifying Islamic banking products at their operational level.

2.7.1 SBP Shariah guideline and model agreements for Islamic modes of finance

State Bank of Pakistan (SBP) has a separate functioning department for Islamic banking name as IBD³⁰ (Islamic Banking Department) and for Shariah compliance supervision a Shariah board is formed at SBP. The board's membership consists of not only renowned religious scholars but also chartered accountant, lawyer and central banker. The Shariah board put its efforts to devise rulings and guidelines that are 100% Shariah compliant and also that is compatible with the legal and financial infrastructure available to the Islamic banks. The Board is also responsible to give ruling on any conflicts arising out of the Shariah Compliance Inspection. It is responsible to provide guidelines to SBP for Shariah aspects of regulations. It helps in product development and provides support for approving any new products developed by the commercial banks. This board has been functional for almost nine years now. The feedback from the industry and SBP

experience with the Shariah board has been excellent. In fact the Shariah board has played a key role in ensuring an issueless promotion of Islamic banking in the country.

SBP Shariah board has devised and approved essentials and model agreements for Islamic modes of financing. These agreements consist of several documents that serve as a legal agreement among the parties involved in the financing agreement. Documents ensure Shariah rulings and standards that are needed to be abided by the participants. Islamic financing transactions are audited by the Shariah advisor working for the specific bank. In our case Shariah advisor for DIB Pakistan will provide external advisory to our group in completing the research work.

Some important documents of agreements and guidelines are;

- Murabaha Facility Agreement
- Musawamah Facility Agreement
- Lease Agreement
- Musharaka Investment Agreement
- Istisna'a Agreement
- Agreement for Interest free Loan
- Mudaraba Financing Agreement
- Syndication Mudaraba Agreement

At operational level this would serve as the most important source for us in order to analyze the Shariah compliance of the contract between the bank and the client. Shariah advisor for the bank is already performing auditing of the contracts with reference to these guidelines we will present the auditing reports of the advisor in a descriptive study.

2.7.2 Introduction to Islamic finance, Mufti Taqi Usmani

Mufti Muhammad Taqi Usmani is one of the leading Islamic scholars. He is an expert in the fields of Islamic Jurisprudence, Economics and Hadith. Born in Deoband, India in 1943 AD and graduated par excellence from Dars e Nizami at Darul Uloom, Karachi, Pakistan. He obtained his Takhassus degree (an advanced degree equivalent to Ph.D.) in

Islamic education from Darul Uloom Karachi, the largest and most renowned Islamic educational institution in Pakistan. He also obtained a Master's degree in Arabic literature from Punjab University, and a law degree (LLB) from Karachi University. Since then, he has been teaching Hadith and Fiqh (Islamic jurisprudence) at the Darul-Uloom, Karachi. He also holds a degree in law and was a Judge at the Shariah Appellate Bench of the Supreme Court of Pakistan till recently. He is currently one of the most authentic Islamic Shariah scholars active in the field of Islamic finance. For more than a decade he has served as chairman or member of Shariah supervisory boards of a dozen Islamic banks and financial institutions in various parts of the world. He presently serves as Chairman of the International Shariah Council for the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain.

Introduction to Islamic finance³⁶ is the most basic book in this field written by Mufti Taqi Usmani, in which he has explained all the fundamental concepts regarding legitimate Islamic contracts that could replace interest (Riba) based conventional banking. In clarifying Shariah rulings he narrated references from all of the Islamic schools of jurisprudence in a very simple plain language.

2.7.3 Guide to Islamic banking, Dr. Mufti Imran Ashraf Usmani

The book 'Guide to Islamic banking³⁴' specifically written for Meezan Bank (which is pioneer Islamic bank in Pakistan) has been the guiding light in the area of Islamic Banking for many institutions, explaining the Islamic modes of finance with practical examples that could hold true in current era.

Dr. Muhammad Imran Ashraf Usmani is a M. Phil and Ph. D. in Islamic Finance and is a graduated as a scholar from Jamia Darul Uloom, Karachi, Pakistan. He also completed the specialization course in Islamic Jurisprudence from Jamia Darul Uloom, Karachi, Pakistan. Currently he is involved in conducting training sessions for Meezan Bank's staff in the area of Islamic finance and has been teaching several subjects of Islamic Fiqh since 1998 at Jamia Darul-Uloom, Karachi, Pakistan. Dr. Usmani has also authored various books on Islamic Shariah and especially his book 'Meezan Bank's Guide to Islamic banking' has been the guiding light in the area of Islamic Banking. Dr. Usmani serves as a Shariah Supervisory Board Member / Shariah Advisor to State Bank of Pakistan, HSBC Amanah Finance, Credit Suisse, Lloyds TSB, Meezan Bank, Pak Kuwait Takaful Co and others. Apart from that we will be conducting in-depth interviews and gathering opinions of Islamic scholars and jurists in this regard, that will be presented in the research report.

2.8 Financial assessment of Islamic and conventional banking products

As our secondary objective is to compare specific products offered by Islamic banks with corresponding products of conventional banks in terms of monetary value i.e. to determine which banking product is cheaper and economical to customers given the same product in the same market and same selection parameters offered by the two competitors (Islamic bank & conventional bank). In order to compare, we need to review some financial concepts i.e. time value of money and present value of future cash flows. A Euro due after five months has more value than a Euro due after ten months i.e. money in hand today is more of worth than same amount of money obtained next day (Berk & DeMarzo, 2009).

SECTION 3 METHOD

3. Method

We require both primary and secondary sources of data in order to execute our research. Secondary data is the already available data in the form of manuals, reports, publications, agreements etc. that we will use for analysis purposes. Primary data is that we collect specifically for the purpose of our project and is not available previously. Considering our research, the main source of primary data is the data gathered through interviews of scholars, jurists and financial experts.

3.1 Secondary data

Secondary data consists of gathered data available at the official web sites of the Dubai Islamic bank (www.dibpak.com), Kuwait Finance House (www.kfh.com/en), National Bank of Kuwait (www.kuwait.nbk.com), Standard Chartered Bank (www.standardchartered.com/pk) and articles related to Islamic finance published on the internet and different Islamic banking magazines. The reference books used as bench mark for data analysis are also a source of secondary data.

3.2 Primary data

Main source for the collection of primary data in our project is survey questionnaires and in-depth interviews with the manager product development and representatives of the Shariah committee of above mentioned Islamic banks. Survey questions are related to different products of these Islamic banks (Mudaraba, Musharaka and Murabaha) and objective is to ask bank's operational policy. Detailed observations will be accumulated by comparing the actual operations of the bank with the standard. Likert scale (0 -10) is used for the response. Standard or benchmark selected is a manual or guide book that describes all the legitimate forms of Islamic contracts and financing modes that could be used as alternative modes of finance without breaking any Shariah ruling. Introduction to below listed standards has been mentioned in theory section and the detailed rules have been explained in detail in section 4.

- SBP Shariah Guideline and Model Agreements for Islamic Modes of Finance
- Introduction to Islamic Finance, Mufti Taqi Usmani
- Guide to Islamic Banking, Dr. Mufti Imran Ashraf Usmani

3.3 Qualitative or quantitative research

We will be using both qualitative and quantitative research methodology in this thesis. Qualitative approach will be used for Shariah compliance and quantitative approach will be used for comparing specific products of Islamic banking with their counterparts' conventional banks since data collected is in form of statistics and figures. We will use Net Present Value (NPV) methodology to compare quotations of specific products. Quotations will be collected from the concerned banks.

3.4 Research methodology

One of the objectives of this thesis is to verify or investigate the Shariah compliance of the current Islamic banking financial products with detailed analysis of the operations of DIB and KFH banks. For this purpose we need to have a benchmark or standard to make a comprehensive comparison against products offered by the Islamic Banks. In this regard the most important consideration is that the standards to be selected must be authentic and reliable, that should have been produced by legitimate, authoritative and trustworthy Islamic religious scholars. Each of the Islamic financial products is based on certain Shariah defined contract or mode of finance such as Musharaka, Mudaraba, Murabaha and Ijara etc. All of these are Islamic terminologies that are defined as legitimate forms of Shariah contracts in different Islamic school of thoughts. Islamic banking products are designed in a way that satisfy and comply with rulings and decree described by these contracts. And obviously the main trait of those transactions and contracts is their interest free nature and the absence of other prohibited features like Gambling. Authentic Islamic scholars have explained the legitimate form and structure of Islamic contracts that could be used in corporate finance activities without violating any Islamic Shariah ruling.

For analysis purpose we will compare the actual financing mode or contract that lies beneath the product offered with the rulings described in the selected standards. Observations collected through comparing the actual with the standard will be presented based on the opinions of the credible contemporary scholars who are amongst the forefathers of Islamic banking in order to make an authoritative judgment and conclusion regarding the operations of the bank in terms of their Shariah compliance.

3.5 Research paradigm

This is a descriptive research project that will present the findings of the analysis based on the opinions of the experts, because the subject matter is related to Islamic jurisprudence and Fiqh (expansion of the Shariah Islamic law). Therefore the approach used for research would be descriptive qualitative research and underlying method of description would be based on inductive reasoning i.e. case will be built with supporting evidences and explanation of the facts and figures and finally conclusion will be given based on the explanation provided.

That concludes the data methodology of our project, now in the next section of the report we will be moving towards the data analysis part of the project. Analysis is performed on the basis of the benchmarks that we have selected, after studying the financial products of Islamic banks under study.

SECTION 4

EMPIRICAL FINDINGS AND ANALYSIS

4. Analysis

In this section, we will discuss in detail the specifications of different products offered by Islamic banks under study and the underlying mechanism that makes them Shariah compliant and differentiate them from the conventional banking products. Basically different modes of financing practiced by the banks are taken up first and then the various categories of products where the applicability of these modes is realized are subordinated under them.

The underlying assumption by us while taking up the products of these bank are that all the offered products with varying financing modes as an underlying mechanism of the bank comply with Shariah. Now the discussion on data regarding the products provided by the manager product development, Shariah advisor and Shariah co-coordinator of the banks and the analysis of that data in the light of our bench marks is to be carried out in this section of our report. The nature of the analysis is qualitative as based on seeking expert opinion in this field of various Islamic jurists described in the benchmarks in terms of their research work and Shariah knowledge of Islamic finance consolidated to provide guidance to potential upcoming researchers and knowledge seekers. The discussion will lead towards achieving our objectives of the study and report that is to analyze the Shariah compatibility of the products in the light of Shariah guidelines which are interpreted by the authentic scholars and finding out that whether the products offered by the DIB and KFH Islamic banks are Shariah compliant or not and hence discuss ethics of these banking principles. It was previously explained in the section 3 that the analysis we provide for KFH and DIB will be against three main benchmarks or standards;

- SBP Shariah Guideline and Model Agreements for Islamic Modes of Finance
- Introduction to Islamic Finance, Mufti Taqi Usmani
- Guide to Islamic Banking, Dr. Mufti Imran Ashraf Usmani

For comparing products of Islamic banks against respective conventional counterparts (KFH vs. NBK and DIB vs. SCB), we will select credit cards, house financing, cash loans and consumer credit products.

4.1 Empirical Findings

The data received from different branches of the banks under study were screened prior to analyzing. We filtered surveys having less than 70% response and having any abnormalities. Below is summary of questions and its response:

A. There is pre-determined ratio of profit in Mudaraba maintained by bank?

Observation	Likerta Scale Range	Frequency	Percentage
Strongly Agree	0 - 1	3	15%
Agree	2 - 4	9	45%
Neutral	5	6	30%
Disagree	6 - 8	2	10%
Strongly Disagree	9 - 10	0	0%
Total		20	100%

B. Bank charges Mudarib fee in Mudaraba?

Observation	Likert Scale Range	Frequency	Percentage
Strongly Agree	0 - 1	1	5%
Agree	2 - 4	12	60%
Neutral	5	4	20%
Disagree	6 - 8	2	10%
Strongly Disagree	9 - 10	1	5%
Total		20	100%

C. Bank passes its own share in favor of depositor in order to avoid dip in depositor's profit?

Observation	Likert Scale Range	Frequency	Percentage
Strongly Agree	0 - 1	5	25%
Agree	2 - 4	4	20%
Neutral	5	9	45%
Disagree	6 - 8	2	10%
Strongly Disagree	9 - 10	0	0%
Total		20	100%

D. Bank charges fee to the customer for provision of financial service like refinancing of extended credit facility?

Observation	Likert Scale Range	Frequency	Percentage
Strongly Agree	0 - 1	5	25%
Agree	2 - 4	4	20%
Neutral	5	9	45%
Disagree	6 - 8	2	10%
Strongly Disagree	9 - 10	0	0%
Total		20	100%

E. Bank charges any premium amount in case of late payments over the settled price as a financial penalty?

Observation	Likert Scale Range	Frequency	Percentage
Strongly Agree	0 - 1	12	60%
Agree	2 - 4	6	30%
Neutral	5	2	10%
Disagree	6 - 8	0	0%
Strongly Disagree	9 - 10	0	0%
Total		20	100%

F. Bank allows customers to buy advance number of units (early payment) without any restrictions?

Observation	Likert Scale Range	Frequency	Percentage
Strongly Agree	0 - 1	2	10%
Agree	2 - 4	3	15%
Neutral	5	1	5%
Disagree	6 - 8	8	40%
Strongly Disagree	9 - 10	6	30%
Total		20	100%

G. Does practice of bank to give cash under cover of Murabaha agreement an ethical solution?

Observation	Likert Scale Range	Frequency	Percentage
Strongly Agree	0 - 1	1	5%
Agree	2 - 4	1	5%
Neutral	5	4	20%
Disagree	6 - 8	3	15%
Strongly Disagree	9 - 10	11	55%
Total		20	100%

4.2 Critical Analysis of Mudaraba based saving accounts

Mudaraba is the basic tool used by K.F.H. to accumulate pool of funds in the bank's accounts. The reserves gathered through Mudaraba arrangement is equivalent to the deposits (saving and current) of a conventional bank. The depositors take the position of owner of money ("Rabb-ul-mal") and bank becomes "Mudarib" by taking the responsibility of managing the funds. One single pool of deposits is created through all of the investments made by the Mudaraba clients irrespective of the nature of product agreement being signed. For the purpose of clarity, in this whole process the joint pool of deposits is termed as Rabb-ul-Mal rather than the individual or specific clients. The bank uses the funds from the pool in suitable Shariah permissible venues to earn expected profits and the returns received are distributed among the Mudarib (the bank) and the Rabb-ul-Mal (the pool). The profit distribution is based on the prearranged agreement between the clients (that constitutes the pool) and the bank. K.F.H. also charges Mudarib fee from the investors (i.e. Rabb-ul-Mal in Mudaraba transaction). Profit is distributed by K.F.H. according to the agreed upon ratio among the clients that is legally written in the agreement.

Bank also owns its personal share in the joint pool in the form of equity invested by the bank, therefore, in addition to sharing profit as Mudarib bank also takes its profit share as Rabb-ul-Mal too. This arrangement is known as Musharaka-cum-Mudaraba Model because it combines two modes of Islamic finance Musharaka and Mudaraba and it is currently being practiced in most of the Islamic banks. Bank is acting as Mudarib and also has invested his share in the investment pool also thereby becoming partner to external clients. Apart from that the clients that constitutes the investment pool, at the back end invisibly becomes partners to each other in sharing of the incurred profit on

the pool of funds invested by them. The profits realized to the investment pool is distributed among the clients according to their shares and terms and conditions but after bank has deducted its profit as a Mudarib plus its profit as a shareholder of the investment pool.

K.F.H. as Mudarib invests funds from investment pools into different avenues and portfolios. Equity investment is done only in the companies that are engaged in Shariah permissible businesses. Majority of the investment is done through Murabaha mode of finance by providing import/export, working capital and project financing facility; and home financing through Diminishing Musharaka model of Islamic finance. In addition to this a small portion of the investment is done in Islamic bonds (Sukooks) offered by equity investment in public limited companies. However equity investment is made only in those companies that are engaged in Shariah permissible business. Another condition for equity investment that has to be taken care of is the amount of debt the company is holding. Central bank of Kuwait's regulatory department for Islamic banking specifies the proportion of debt in the company's capital structure that limits Islamic financial institutions to invest in that company. The rate varies at different times and currently is prevailing at about 40%. The regulatory department and Shariah advisory board are putting their efforts to minimize this proportion as low as possible. In next sections, we will discuss some of the critical factors that were identified during the analysis part of the financial products offered by K.F.H. under Mudaraba mode of finance.

4.2.1 Predetermined ratio of profit

The very basic condition for the validity of the Mudaraba is that the proportion of profit should be known to both parties before the start of the Mudaraba and both parties must have made consensus upon that decision. Mufti Taqi Usmani writes in his book:

“That in the very start, the parties, on their authorized profit, give their consent on a specific amount of the actual profit” (Introduction to Islamic Finance, p-33).

And in State bank of Pakistan's Essentials of Islamic modes of Finance it is written that, *“The profit shall be divided in strict proportion agreed at the time of contract and no party shall be entitled to a predetermined amount of return or remuneration (Essentials of Mudaraba mode of Finance, clause-5)”*.

Therefore in order to make Mudaraba a Shariah compliant contract the exact proportion of profit should be known to the clients prior to the start of Mudaraba period, otherwise Mudaraba contract would become invalid. This condition has been clearly explained in all of the reference literature that we are using as benchmark. Now here to perform analysis we will compare the actual practice of the bank with the standard.

K.F.H. declares Mudarib (the bank) share and Rabb-ul-mal (the pool) share in the beginning of the Mudaraba period at their branches and on their website. The last declared profit proportion was specified in year 2005 before starting of 3rd quarter (Mudaraba period) i.e. 1st July 2005, and it was 50-50 %.

Table 3 : Profit distribution proportion between Mudarib and Rabb-ul-Mal

Account Holder	K.F.H.
50%	Maximum up to 50%

This shows that the above mentioned conditioned is fulfilled by the bank, that is it has explicitly mentioned the profit proportion for the Mudaraba business. But this is true in case when we consider the whole joint pool as Rabb-ul-Mal, however as far as the individual customers are concerned than there is no such mechanism in the bank that tell them the true proportion of profit they will get. This problem become more complex because the bank is conducting Mudaraba in a dynamic environment, in which it has allowed certain account type holders to withdraw capital. And also new clients can come and join the Mudaraba in between and subsequently their invested capital will be added in the joint pool. For this purpose a 'daily product basis' method is adapted by K.F.H. that determines the actual profit ratio for the specific client at the end of the particular Mudaraba period when the actual profit is realized. 'Daily product basis' method calculates average profit amount on per one Kuwaiti Dinar per day basis and subsequently calculates profit proportion of the respective client's investment. Mufti Hameedullah Jaan⁸ and Mufti Zarwali khan²⁴ commented on this process by saying that this procedure of calculating profit proportion at the end of the Mudaraba period invalidates the contract, because the basic condition for Mudaraba is violated.

K.F.H. has declared quarterly based Mudaraba periods i.e. Mudaraba starts at the beginning of the quarter and ends when the period ends. At the end of the period profits are calculated for each account type and subsequently for each customer. At the start of the period weight ages are defined and intimated to the customer through website. As previously explained those weight ages help to determine the actual profit proportion further at the end of the period. However, before the start of the Mudaraba period clients only knows the weight ages rather than the actual profit proportion. Actual profit proportion is calculated at the end of the period when the profit is realized.

4.2.2 Mudarib fee

Another condition for the validity of the Mudaraba contract is that the Mudarib who is managing the funds provided by Rabb-ul-Mal does not have the right to claim any kind

of Mudarib fee from the bank. Mufti Taqi Usmani¹ writes, “The Mudarib cannot claim for the monthly wages or any payment or compensation of the work done for Mudaraba, other than the predetermined and decided amount of the profit. (Introduction to Islamic Finance, p-34)”.

K.F.H. currently charges Mudarib fee apart from the share in the profit as Mudarib and Sharik (one who shares). It is written in their account opening agreement as,

*“In calculating Profit applicable to saving accounts **the Bank shall deduct proportionate administrative costs at actual** and a profit share of the Bank as Mudarib, which would be 50% of the realized profit. The Bank may change its profit share and weight age applicable from time to time details of which will be available at the Bank and its website for information of the customers.(K.F.H. terms and conditions for saving accounts, clause-8)”.*

Similarly Dr. Mufti Imran Ashraf Usmani²⁵ in his book Guide to Islamic banking writes;

“Mudaraba will not bear any expenses for food, clothing, transportation and medicinal on part of Mudarib. The capital will cover the expenses mentioned above for him if he is going for a business trip and stays overnight .If Mudarib travels for more than 48 miles without overstaying the night, the Mudaraba will not bear operating expense.”

This was also described by the Product development manager and Shariah advisor of the K.F.H. that they charge Mudarib fee from the clients by deducting it from the actual realized profit. The bank deduct Mudarib fee under the name of Administrative costs. Mufti Taqi Usmani¹ said in his book that all the schools of Fiqh are unanimous on this point that Mudarib cannot charge fee for the work from Rabb-ul-mal rather the only legitimate share is in the profit earned through Mudaraba. Therefore this practice of the bank seems to violate the condition of the legitimate Mudaraba agreement.

Mufti Zarwali khan²⁴ commented on this practice of the bank after giving references from Islamic Fiqh and Jurist’s verdicts that this practice of bank is illegal in Shariah therefore there is no reason to call it Mudaraba and Musharaka (which are legal terminologies in Islamic Fiqh)

4.2.3 Mudarib share rate variation (in the favor of depositor)

It is a usual practice of the bank if at the end of any period if profits earned are less than the usual rate of profits previously given to the clients then Mudarib i.e. K.F.H. passes on its own share of profit to the clients to compensate them for the low returns. This practice is done by the bank to retain their clients. Continuous practice of this will

certainly make the illusion of making fixed payment to the depositors, rather than having profit and loss sharing accounts.

4.2.4 Findings

It is explained in the critical analysis section that we found certain discrepancies in the transactions and agreements of Islamic financial products of K.F.H. and identified the deviations that it make from the standards and benchmarks. For Mudaraba mode of Islamic finance the bank violates three main conditions of legitimate Mudaraba contract

- I. Due to the complex existing structure of profit distribution mechanism, exact proportion of the profit is not known to the Rabb-ul-mal (clients) before the start of the Mudaraba transaction. The problem mainly arises due to the single joint pool that is created by the bank for all types of deposits, with current account holders and some term deposit holders having the option to withdraw money under certain terms and conditions. The 'daily product basis' method adapted by bank cannot be justified as just profit distribution under Shariah rulings. The concept of weight ages assigned to different account holders before the start of Mudaraba period also does not conform to the obligatory condition of deciding the exact proportion of profit in the beginning of the Mudaraba agreement.
- II. K.F.H. charges Mudarib fee under the name of administrative charges, this also invalidates the Mudaraba agreement, because under the terms of Mudaraba, Mudarib can only share the profit based upon the pre-determined agreed upon ratio. Administrative costs like salaries of employees, electricity bills etc are the responsibility of Mudarib (not Rabb-ul-mal).
- III. K.F.H. passes on its own share of profit to the clients to compensate them for the low returns, in case if at the end of any period profits earned are less than the usual rate of profits previously given to the clients. This practice is done by the bank to retain their clients. This invalidates the condition of profit sharing with fixed pre-determined proportion, because the bank continuously practices this scheme. Continuous practice of this will certainly make the illusion of making fixed payment to the depositors, rather than having profit and loss sharing accounts.

4.3 Critical Analysis of Murabaha as an underlying mode

A financing tool used in the Islamic financial infrastructure for trade financing is considered as a trading mode of financing. 'Murabaha' is the only option adopted by the bank amongst different alternative trading modes like 'Musawama', 'Salam', 'Istisna' etc. Different products in this category with the underlying mechanics of Murabaha are

currently being offered by the bank in the areas of different types of financing like import, export, working capital and infrastructure financing (local Murabaha) and export refinancing.

4.3.1 Rules of Murabaha sale

Following are the rules taken from reference books by Mufti Muhammad Taqi Usmani¹ and Mufti Imran Ashraf Usmani²⁵ respectively that completes and validates the Murabaha sale transaction.

- I. At the hour of sale, the subject of sale must exist. Anything that does not exist at the time of sale cannot be sold.
- II. The supplier should own the theme or subject matter at the time of sale. If something has not being acquired and sold then the sale becomes void.
- III. The subject of sale must be in a physical or constructive possession at the hour of supply of the seller. Constructive possession means that the product commodity hasn't been delivered to the holder (owner) of it yet all its rights and responsibilities including the risk of its annihilation and damage have been imparted on to him .The sale remains void unless the constructive possession is attained in the absence of physical possession.
- IV. The subject of sale should be a property having some value. Therefore, a commodity with no worth or value is unable to be purchased or sold.
- V. Anything that is used for un-Islamic purpose can't be subject to sale.
- VI. The sale must be done in an absolute and instant manner and should not be contingent on future event or date because in that case sale will be void unless refreshed on that specific future date or event.
- VII. The buyer must know the subject or theme of the sale.
- VIII. The purchaser of a commodity should be absolutely sure of the deliverance of the product that is been sold.
- IX. The price of the subject should be certain as this condition is very necessary to validate the sale and in case there is no certainty about the price or cost or a product, the sale is cancelled.
- X. The sale must be unconditional. If a condition is put on a sale then it is considered invalid unless that in accordance with the usage or consumption of the trade, the condition is standardized as a part of deal.

Above mentioned conditions are being adhered by the bank and are incorporated in the contracts that take place in between the client and the bank relevant to the Murabaha sale transaction. Now we move on to the different agreements between K.F.H. and the client which take place step by step at various stages of the

transaction. The agreements have to be done in a Shariah permissible manner and not according to the interests of the bank or the client. Therefore following a step by step approach is binding on both the parties and undergoing all the agreements at the start of the transaction or at the end of the transaction would be questionable from Shariah perspective. Now let us see how the bank and the client go through those agreements in practice as follow:

- I. First of all an overall agreement is signed between the bank and the client whereby the bank and the client are on mutual collaboration with each other in buying and selling and promise to purchase and sale the commodity on regular basis on a decided proportion of profit that is been added to the cost. Any specified limit up to which the financing facility may be made is mentioned in the agreement.
- II. After that an agency agreement is signed between both parties in which the bank appoints the client as its agent to purchase the commodity from the supplier on its behalf.
- III. Then the product is sold to the customer on account of bank and customer takes the possession of it as an agent of the bank.
- IV. After taking the possession of the commodity client informs the bank about the possession and makes an offer to the bank to purchase it.
- V. Finally, the bank accepts the offer and sale is concluded transferring the ownership and risk of the asset to the buyer finally.

All the above mentioned conditions and agreements undertaken are essentially required to validate Murabaha sale transaction. It is important to note that when the possession of asset is taken by the client, its risk remains with the bank for a time elapsed between possession by client and the final acceptance of the bank to sell it to the client concluding the sale and it also ensures a sale of commodity with constructive possession on part of the bank. The risk bore by the bank is very crucial in terms of measuring up to Shariah requirements and differentiating it from the interest based financial transaction.

4.3.2 Factors invalidating Murabaha sale

If there is some deviation found in following the rules of Murabaha sales then anything incorporated in the agreement other than specified in the rules tend to invalidate the contract of Murabaha sale. For instance if the commodity to be sold is not yet in an existing form and one sells it depending on its future existence like the calf who has not yet been borne but sold against some price then the contract would be invalid. This

future dependence and non-existence of the calf physically are the factors which invalidate the Murabaha sale contract.

4.3.3 Rules of credit Murabaha

In sale on credit all that stuff can be called as capital in which inherent value is more important than the quality and can be put up for sale on delayed payment basis. Following are the conditions being met by the bank for deferred payment sale:

- I. To negotiate and settle the price to be paid is agreed by both the parties at the time of the deal. Any amount of profit could be included in the settled price but without any doubts about interest (*Riba*).
- II. The bank gives the complete possession of the good to the buyer and the deferred price of that good is considered as debt against buyer.
- III. Once the price is settled after negotiation and fixed then it can't be altered like decrease for early payments (discounts) or increase for default (premium).
- IV. The deferred price is more than the cash price and it is fixed at the time of sale.
- V. The due time of payment is fixed by the bank with reference to a specified time period like six months or one year.
- VI. In order to ensure the timely payments of the installments on due date bank is pressurizing the customer to donate some specified amount to the charity account of the bank in case of default and the charity amount does not become a part of the income of the bank and instead is given in charity to the poor and the needy. Currently K.F.H. reserves the right to charge over and above 2% of the agreed rate as a late payment penalty.
- VII. The bank requires the company (client) to maintain a current asset and current liability ratio of 1:1 as per the instructions of the regulatory authority and in case of failure to abide by the instructions the imposed penalty by the central bank would be recovered from the company (client).
- VIII. It is the requirement of the bank that the company provides the bank with the latest audited accounts of the company.
- IX. The bank reserves the right to cancel the availability of this arrangement at its sole discretion on account of non-utilization of the same within three months.
- X. If at any time bank becomes aware of any matter relevant to the company not known to the bank as at the date of this facility letter that could potentially impact negatively upon the credit worthiness of the client in the opinion of the bank then the commitment of the bank be deemed to be terminated and no further transaction will be undertaken.

- XI. The bank requires a security from the buyer in the shape of advance or an article to secure the debt.
- XII. The bank shall be furnished with satisfactory banker's references on you and any other related information on you as it may reasonably require.

4.3.4 Critical analysis of credit Murabaha

Now after over viewing the conditions which make the product Shariah compatible, we will move on to the analysis of those conditions which are found in existing critique by different contemporary scholars, appearing as weaker areas in terms of keeping much space for improvement over the time to further strengthen the existing credibility of the financial practices of the bank or has potential to damage the existing credibility of the product offered and the bank and industry consequently.

In the following part we will discuss some of the main critical factors which are very important in terms of establishing the Shariah credibility of the product and provides a good evaluative measure of the product too from Shariah stand point.

4.3.4.1 No discounts or premium over the face value

One critical point in case of meeting the conditions of credit Murabaha sale is that bank cannot charge any premium amount over the negotiated price and neither discount the client for early payments as the credit amount assumes a form of debt which cannot be negotiated other than par value. Currently in practice for late payments some financial penalty is being charged to the customers with an objective to ensure timely payments which would not be possible otherwise, keeping in view the moral and ethical issues prevailing in our society. The fine charged by the bank to the customer is deposited in the charity account of the bank and later on given in charity to the needy and indigent with an intention to purify the income of the bank and help extended to the deserving people of the society. The penalty mechanism in place charges the client a fine on daily basis after the due date and it keeps increasing with the passage of time as the number of days after the due date increase.

As far as the matter of early payment is considered then no discount could be given according to conditions but in practice as reported by the manager product development of the bank, to some customers under certain circumstances like exceptional situations the discount is given by the bank. It is specifically mentioned by bank that it is not in the usual practice but in few odd cases it is being done. It is specifically mentioned in the reference book by the Mufti Taqi Usmani¹ that discount

could be given to some customer who is really needy at the sole discretion of the bank on voluntary basis for instance to some poor farmer who has purchased the tractor for agricultural purposes from the bank on Murabaha basis.

4.3.4.2 Post shipment export refinancing

Currently the targeted areas by the bank are export, import and working capital. Now if we throw light on the post shipment export refinancing, it is found in the process that the exporter after selling the goods on credit comes to bank for a financial back up and support. Then the extended credit by the exporting firm is refinanced by the bank after considering those receivables as a security deposit to extend new credit facility to an amount equivalent to the receivables for the purchase of goods or commodities on deferred payment basis which is repayable by the receivables/ bill of exchange deposited with the bank as a security. The bank and the customer undergo an agency agreement where the bank assumes the role of agent of the customer to collect those receivables from the debtor of the customer. Now the point of concern is that whether it takes a form of sale of debt or not because the arrangement done between the two parties is very close or in some way similar to sale and purchase of the debt which is strictly prohibited in the Islamic injunction above or below the par value of the debt. Here in this case the debt is not discounted while being sold which normally happens in the conventional banking practices but the bank is charging fee to the customer for provision of this financial service which again take the form of interest in some way or other. So this is the weaker area found so far in terms of its full Shariah compliance as far as the financing under Murabaha mode is concerned because the sale of debt at discount or premium is strictly prohibited by Shariah and majority of the Islamic scholars have developed a consensus on this issue.

4.3.4.3 Promise to sell and buy

Another important aspect needs to be sorted out and made clear in Shariah perspective is regarding the promise to sell by the seller and the promise to buy by the buyer, who are bank and the client respectively in this case. The promise made by both parties cannot be made conditional to actual sale. Because if it is made conditional then the actual sale cannot be taken in to effect and remains void so the promise is not part of the actual sale contract. The promise could be done separately to create a moral obligation on both the parties and by this the validity of actual sale remains safe from any kind of element that could potentially harm the validity and make it void. Murabaha transaction is validated by following all the basic rules that govern the Murabaha transaction which has already been explained above in detail. Now whether the promise

is legally binding or not could be discussed in the light of arguments by various scholars belonging to different school of thoughts. The Islamic jurists^{35,36} say that if the promise made burdens the promise with some sort of liability then the promissory could be enforced by the court of law to fulfill the promise and if it is not full filled then the direction could be given to the promissory to make compensation to the promise against the incurred damages or losses due to non-fulfillment of the promise.

4.3.4.4 Existent critique by scholars

There are some issues regarding this approach of the bank and the critique by various contemporary scholars like Mufti Hameed Ullah Jaan¹¹ (*Head Mufti Jamia Asharfia Lahore*), Molana Saleemullah khan (*Jamia Farooqia, Karachi*), Mufti Zarwali khan²⁵ (*Jamia Ahsanul Uloom*). They that you one can never give charity through an income that is earned through illegitimate ways and this cannot be justified in Shariah perspective. As reported by the Shariah coordinator of the bank that there is no alternative solution to this step taken by the bank until current point in time and if some better solution comes then the bank would instantly switch to that. Similarly there is a clear cut violation of the basic conditions required to validate the Credit Murabaha if the determined price is decreased in case of payment before due date. If the practice is exceptional for some cases even then it weakens the Shariah compatibility of that particular transaction and cant' be justified by all means in Shariah perspective because the extended credit to the customer by the bank in the form of deferred payment has taken the form of debt and you can never charge premium or discount the debt amount.

4.3.5 Murabaha for cash

Islamic banks do not deal with cash loans (personal loans) as markup is not allowed in Islam. So in order to target those customers who want to avail personal loans, K.F.H. has developed a mechanism which is a work around solution. K.F.H. has appointed few general trading companies as its agent. Now if customer wants to apply for cash loan, K.F.H. first advises customer to get quotation of that amount from one of its agent. Customer will bring quotation from that agent and present to K.F.H. Now K.F.H. assumes that this quotation are of goods which customer needs to buy from that company. So K.F.H. will do a Murabaha agreement with customers and issue payment invoice for that quotation. Customer has to pay cost plus agreed on fixed payment in installment to K.F.H. Now customer will take that payment invoice, which is on name of that company, and asks to buy and resale the goods. Obviously, that company will sale on the invoice amount and rebuy the goods on some discounted rate and will pay cash to the customer. So the customer has to pay fee twice for getting the cash (i.e. initially to bank and then to agent). This practice is extremely unethical because there is no real stuff

bought/sold by customer/bank/agent. And everything is assumed to be on quotation (paper work only). Bank is just looking for the work around to deceive the law. Although the bank claims that this solution is in compliance to the law, it is not ethical.

4.3.6 Findings

Having highlighted the above mentioned issue and looking for better alternate solution is our responsibility but first let's have an overview about figuring out different substitutes to this approach. For instant if we say that instead of charging a penalty the bank should go for selling the property pledge with the bank as collateral or whatever form of collateral exist with the bank should be utilized instead of charging the penalty which is in the form of charging money for money and takes the form of interest.

The issue was discussed with the Shariah coordinator of the bank and they came up with an opinion that this process is very inconvenient and hectic. The bank would be then involved in this activity of bidding the property of the defaulters spending much of the time and cost. The process is time consuming and costly as involves legal actions to be taken after the lawsuit by the bank against the customer and the court of law has to be involved in it to legally enforce the whole process. In the courts of law, the whole process of filing the suit, legal notices, hearings and then final verdict in the favor of any of the party may take very long because of the slow proceedings from one step to another. And if the bank is confronted with not one, two or few but so many cases of default that could potentially arise then managing this situation in an effective way so that the severity of the situation does not impact the overall performance of the bank, in this competitive financial environment becomes very difficult for the bank.

One cannot deny the importance of an alternate solution which is hard to execute but fits the Shariah requirements compared to the solution easily achievable but controversial from Shariah stand point. However, as the Islamic financial system is evolving and things would take time to be improved and refined to better fit the Shariah demands so we can conclude that given the existing conditions and circumstances so far no feasible solution other than giving the financial penalty to the charity has been found. The contemporary scholars who are amongst the founders of the Islamic financial system are of the view that given the prevailing circumstances the option of charging a penalty which goes to the charity account is the best amongst different alternatives. The penalty clause in the contractual agreement should reflect it as a volunteer step by the client or a form of promise to pay in charity account and should not reflect as if imposed on the client. In the agreement of the bank, we find that the

tone used by the bank like 'the bank reserves the right to charge you in case of default' makes the Shariah credibility of the product weak.

All the critical factors discussed before in the analysis part related to discounting the charges for early payments and post shipment refinancing that takes the form of conventional refinancing comprising sale of debt are the weaker areas found in the products developed on the basis of Murabaha mode. So unless all these weaker areas are rectified in the light of Shariah guide lines the products cannot be termed as Shariah compliant products. These are ought to be addressed in letter and spirit to further improve and strengthen the evolving Islamic financial system.

4.4 Diminishing Musharaka as an underlying mode

Products like home, project and construction (individual or commercial) financing are being offered by the Dubai Islamic Bank (DIB) to its clients with financing under the mechanism of diminishing Musharaka. The details of the mechanism reveal that the prospective client accesses the bank to seek financing for the purchase of a house or wants to start a new project, which requires a financial support. All the terms and conditions are included in the agreements of Musharaka. The arrangement made in the agreements leads to the joint ownership of the bank and the customer in the asset purchased or a commercial enterprise having a property value thus creating a partnership through Master Musharaka agreement. Our discussion in the report will be specific to the house financing, a product that falls in this mode of financing.

The share of the financier, bank in this case, is further split in to the different units which are purchased by the client periodically until all the shares are purchased and the client becomes the sole owner of the whole property. The price of the shares is determined at the start of the contract and then it is not revised throughout financing period. For instance if at the start of the partnership bank owns 80% of the shares and rest 20 % by the client, the bank then lease out its shares to the client for usage and receive rent against it on monthly basis. A periodic term is decided between both the party for the sale and purchase of units owned by the bank which mounts to repayment of principal and thus increasing the share of the customer and decreasing bank's share in the property. Accordingly the rent received by the bank against its property also reduces. This is how the procedure follows and at the end of the term the bank is left with no share in the property and the 100% ownership lies with the client. It is due to this procedural mechanism it is termed 'Diminishing Musharaka' as the share of the bank in the partnership diminishes over the time. In the following the whole arrangement of this financing scheme is summarized in the form of points reflecting the theoretical implications in terms of practice on part of the bank:

- I. Establishment of combined cooperative possession (Shirkat ul milk) by entering in to master Musharaka agreement.
- II. Giving the share of the bank to the customer on rent.
- III. Promise from the customer to buy the components of share of the bank
- IV. Actual buying of the components of the share of the Bank

4.4.1 Critical analysis of home financing under diminishing Musharaka

Moving towards the critical analysis of this mode of financing, we will be picking up different important factors pertinent to this mode and their relevance from Shariah perspective for discussion and in the light of our reference sources of Islamic Fiqh the discussion on the various matters would proceed.

4.4.2 Promise to sell and buy

There is one another important aspect to be cleared in Shariah perspective is regarding the promise to sell by the seller and the promise to buy by the buyer which is DIB and the client respectively in this case. This promise made by both parties cannot be made contingent on actual sale. Because if it is made conditional then the actual sale cannot be taken into effect, so the promise is not part of the actual sale contract. The promise could be done separately to create a moral obligation on both the parties to sell and buy the units of shares of the bank. Now the point of discussion is whether that moral obligation created through the promise is binding on the promissory or not. In which circumstances they could be legally enforceable by the court of law and could not be. If the promise made creates some sort of liability on the promise then the promissory is ought to fulfill this moral obligation and if deviation is found then the promise could be legally enforceable by the court of law.

4.4.3 Buying shares in first year

It is mentioned in detailed contract that client cannot buy more than one unit (share) per month in the first year. This will ensure that bank receive maximum profit during first year. This condition is unethical as it deprives client of its right to buy as many shares as he/she can and thus save more money.

4.4.4 Findings

The analysis reflects that the critical factors which could raise questions on the Shariah credibility of the product are addressed well in the light of the guide lines given by the

contemporary scholars with exception of constraint on buying more than one share per month in first year. So based on this we can say that this product complies with Shariah.

4.5 Ijara as an underlying mode

Currently in the Islamic banking practices, Ijara is one of the prominent modes for financing used as a financial instrument. It finds its application on various products as an underlying mode and mechanism but amongst the different products engineered on its basis the 'car financing' is the most popular. It is also termed as a 'leasing mode' of financing. Apart from car financing the bank is currently financing the plant and equipment too using this mode. The basic terms and conditions of the contract of lease apply on both of the products and the same procedure is followed in carrying on different agreements made under this arrangement to conclude and validate the lease. In our discussion here we will be restricting to details specific to car financing and on the basis of that the whole case will be built that would lead towards the analysis of the product finally.

4.5.1 Mechanism of Ijara

Now let us see how the financing proceeds through this mode between the DIB and the customer interested in seeking this credit facility. The customer approaches the bank and inform about its requirements of purchasing a car through this facility. The bank after checking the credit worthiness of the customer requires a security deposit from the customer in the form of down payment which is some percentage like 15 percent of the price of the car which is to be purchased. Then bank purchases the car from the market supplier and through a lease agreement between the bank and the customer leases out the car to the customer on rent. The bank assumes the role of lessor after leasing out its asset to the customer and the customer becomes lessee. The repayment schedule is prepared by the bank in the form of installments due to be paid by the customer on monthly basis. The installment includes the rent of the car and the repayment of principal amount invested by the bank. The rent is determined with reference to the KIBOR (Karachi Inter Bank Offer Rate) on the principal amount.

4.5.2 Valid conditions for Ijara

There are certain conditions required to be met to validate the whole leasing process mentioned in the book by Dr. Mufti Muhammad Imran Ashraf Usmani²⁵ and in case of not measuring up to those stipulations specifically, the lease remains void. So let us have an over view of all those necessary conditions in the following:

- I. The transfer of usufruct by the lessor to the lessee only and not the ownership for specified time period and consideration.

- II. Unlike sale agreement, lease agreement could be attributed to some future date.
- III. The subject of lease should be valuable, identified by the parties and quantified.
- IV. The subject of lease should not be some consumable good because only the usufruct is transferred to the lessee and ownership remains with the lessor. So if there is something that can't be used with consuming it can't be leased out e.g. grain in the form of wheat or maize and money are consumable goods.
- V. All the liabilities attached with the ownership of the asset remains with the lessor as he possesses the ownership in case of lease and only usufruct is transferred to the lessee. The risk of the asset remains with the lessor for factors beyond the control of the lessee during the whole lease period. The lessee is liable for any harm to the asset due to his misuse or negligence to compensate the lessor.
- VI. The lease term should be determined in clear terms before the start of the lease.
- VII. If a specific purpose of use of the leased asset is identified in the lease agreement then the lessee can't use the asset for a purpose other than specified in the contract. In case there is no specification then the asset could be used by the lessee for whatever purpose it is used in the normal course of life.
- VIII. The rental payment must be determined for the whole lease period at the time of the contract.
- IX. Rental payment can't be increased unilaterally by the lessor and if it happens then that agreement would be void.
- X. The lease period will start from the date when the asset is delivered to the customer on lease and accordingly the rental payment shall start from that date onward.
- XI. Variable rentals could be determined for the long term leases to counter market forces changing from time to time. In this situation the lessor has two options either to increase the rent with fixed proportion after a specified period or to tie it with the changing variable benchmarks e.g. inflation, taxes or mostly in the financial market it is interest rate.

Following are the conditions being met by the bank (DIB) and the customer while undergoing a lease agreement between each other.

- I. The term of the lease is defined and mostly it is three to five years.
- II. The Installment schedule of rental payments is prepared by the bank is mutually agreed upon by both the parties.
- III. The title and ownership of the asset remains with the bank (lessor) and only usufruct is transferred to the lessee (client) for an agreed period against the rental consideration.
- IV. The risk of the asset remains with the bank during the whole lease term.
- V. The bank (lessor) reserves the right to increase the profit rate/rental payment.
- VI. In case of delay of installment from the due date, the bank charges the penalty 2% over and above the determined rent which goes to the charity account of the bank. This step also puts pressure on the customer in terms of ensuring timely payments of installments.

4.5.3 Agency agreement

The bank and customer undergoes an agency agreement based on which the customer purchases the asset from the supplier on behalf of the bank and the payment is made by the bank. After this the contract of lease is made between both the parties and this contract renders the asset to the customer (lessee) to use the usufruct of the asset while keeps the ownership of the asset with the bank(lessor) and accordingly risk remains with the bank. In a separate agreement bank makes a promise to sell the asset at the end of the lease term to the customer (lessee) and gives him/her the option to purchase or not. If the customer exercises this option which normally in all cases happens then the car/asset is sold to him/her against the security deposit made with the bank before the start of the lease through a new sale agreement. This is how the whole procedure of Ijara financing is followed in this Islamic bank.

4.5.4 Critical analysis of Ijara contract

There are some very important factors currently in the practice of DIB which require discussion from Shariah standpoint and to evaluate that where they stand in Islamic jurisprudence in playing a role to differentiate Ijara transaction from the conventional financial lease. The critical argument and then the counter argument highlighting the weaker aspects of this mode of financing and defending the position of those particular weak factors respectively which are essential to build the Shariah credibility of the product designed on the basis of this mode.

4.5.4.1 Factors differentiating Ijara from conventional lease

There is enormous critique found on this mode of financing due to its similarity with the conventional financial lease. If we analyze the methods and procedure then a huge resemblance is found between the both. But if we look at both the leases thoroughly then we find out that in terms of contractual differences present in the agreements of the two, the Ijara could easily be separated from the conventional one. In the conventional lease the two transactions of lease and sale are combined in a single agreement and are done at the start of the lease. In this case the sale is void as it cannot be attributed to some future point in time. But in case of Ijara, first the bank goes through a lease agreement with the customer and then at the end of the lease term a different new sale agreement is undertaken where the asset is sold to the customer against the book value of the asset. The security deposit initially submitted by the customer before the start of the lease is considered as a book value of the asset. So based on this factor we can say that it is different from the conventional lease and tries measuring up to Shariah requirements.

Another basic factor on the basis of which we can easily differentiate between the conventional financial lease and the Ijara is that in the former one the rental payment starts with the payment made by the financial institute (lessor) whether the delivery of the asset has been made to the customer (lessee) or not and it mounts to interest on the money given to the customer if the delivery has yet not been made but in case of Ijara the rental payments starts with the delivery of the asset to avoid that element of interest. In the Ijara, throughout the lease term the risk of destruction of the asset remains with the lessor which is very important in bringing Shariah conformance in the product.

4.5.4.2 Critique on rental payments

The bank reserves the right to increase the rental payments as per decided in the agreement with the mutual consent of both the parties. So accordingly the rental payments are revised by the bank after every six months. This step is taken by the bank in order to cater the fluctuating market forces specifically when the lease period is long. The contemporary scholars have allowed tying up the rental payments to some variable bench mark which is well known and well defined and leave no space for any kind of dispute. So the bank is keeping KIBOR as a variable reference point as per the regulations of State Bank of Pakistan.

There are certain objections on this arrangement of the bank based on two grounds. The first one is that while subjecting the rental payment to the interest rate makes it similar to an interest based transaction. So the counter argument in this regard is that

by making a reference of rate which is being used by illegal transaction does not impact the credibility of legal transaction under gone with a completely different way from the conventional one meeting all the Shariah requirements of a valid lease. So keeping an interest rate as a benchmark cannot render the transaction illegal because any rate of rent could be decided upon by the two parties getting in to agreement.

Another objectionable argument is that tying up the revision of rental payments to fluctuating KIBOR brings in the element of uncertainty (*Gharar*) in the transaction which weakens the Shariah conformity of the product. Now to counter this objection the contemporary scholars have given a solution in order to overcome the element of uncertainty (*Gharar*) which could arise in some exceptional situations to a significant amount impacting a status of either of the party in the agreement. The suggestion¹¹ is to put a ceiling and floor functions on the interest rate in terms of revising the rental payment with respect to change in the interest rate and it should be decided in the base contract. The limits would imply that the rent can't be increased above the upper limit and decreased below the lower limit balancing out the two positions of the parties in the contract for instance the upper and lower limits are 20 % and 10%. It would mean that the rent will not increase more than 20 % and decrease more than 10 % even if the interest rate has increased beyond the upper limit or decreased below the lower limit.

4.5.4.3 Violation of a basic condition of Ijara by bank on ethical grounds

If the usufruct of the asset is lost due to a factor beyond the control of the lessee, for that particular period the lessee is not liable to pay rent to the lessor as the rent is charged against the usufruct. This factor is very crucial in terms of differentiation from the conventional lease and building up the Shariah credibility of the product as it comes in the basic conditions that validate the Ijara lease. Our data collected in this regard from the interviews conducted with the persons concerned with the development and designing of the product on the basis of Shariah and ensuring their implementation on Shariah basis who are manager product development and the Shariah coordinator of the bank respectively reflect that in practice of the bank this basic condition of the valid lease is not being translated. The reason found is that the bank does not get claims from the client that he is facing a situation where the usufruct of the asset is lost due to some factors beyond his control for instance a road accident and the car will not be in a working condition for the next two weeks and the rent for that particular period should be waived off. Now the point of concern is that why such kind of claim is not arising and what is the true story behind it. The answer to this question is that those customers are not aware of this particular fact that gives them the huge incentive if practically done at the time of the agreement. So in this way the customer is blind to this fact and cannot avail this opportunity which is not found in the conventional lease. This deliberate

ignorance of the bank towards meeting the basic Shariah condition of the Ijara lease puts a big question mark on the Shariah credibility of the whole product of the bank and hundreds and thousands of transactions made related to that product becomes doubtful from Shariah practice. In fact if the basic condition that validates the Ijara lease is not made then the product becomes automatically non-Shariah compliant and this is our finding in case of 'car financing' a product offered with an underlying mode of Ijara.

4.5.4.4 Critique on Takaful premium

The bank (lessor) being the owner of the asset bears all the risk attached to it. So in order to minimize the risk bank takes the services of a Takaful (Islamic insurance) company which covers the risk of the bank on the leased assets. For that matter bank makes a Mudaraba arrangement with the company and invests in the Takaful fund of the company. Currently, Pak-Qatar Takaful Company is rendering this service to the bank. The company as a Mudarib manages the fund and invests it to get returns. The profit earned by that investment is distributed among the company and the bank after deducting the administrative costs of the company. The income that is generated from this investment is used to serve any claim that would come from the customer in case the asset is damaged due to some factors beyond the control of the customer for instance in case of an accident of the car. The cost incurred in the repair of the damage is born by the bank and the returns from Takaful fund are used to pay the repairing cost and to bring back the asset in to usable condition for the lessee.

Now the point of concern is that the bank should cover the risk on assets by Takaful at its own being the owner of the asset. But in actuality it does not happen and in fact that cost is passed on the customer though not explicitly but implicitly while determining the rental payment this factor is considered up front and implicitly made a part of the rental payment which puts a big question mark on the Shariah credibility of that rental amount earned by the bank and contributing towards the revenues and finally the net income of the bank.

4.5.5 Findings

As the essence of the Ijara contract is that the Lessor charges a rent from the lessee for the usufruct of the asset delivered to the later by the former and in case the usufruct is lost due to some factors beyond the control of the lessee then the lessee has an incentive get the rent exempted for that particular time period. But in actual practice bank (lessor) while undergoing an agreement with the client (lessee) does not inform the lessee about this incentive and therefore no claims regarding that are intimated to the bank and served accordingly even if some customer has faced a situation like that. So this unethical practice by the bank weakens the Shariah credibility of the whole product of Ijara financing. Similarly the Takaful premium should be borne by the bank

only being the owner of the asset and should not be passed on to the consumer implicitly in the monthly rental payments thus decreasing the rental payment compared to one being charged in the current practices. Unless these discrepancies are not resolved, the product cannot earn strong Shariah credibility irrespective of the fact whether the factor damaging the credibility is legal or ethical. In this case it seems to be more of an ethical than legal. But it has a potential to raise so many questions on the credibility of the product as this unethical practice could not be justified by the representatives of the bank which is the Shariah committee.

4.6 Comparison of Islamic banks products against conventional banks products

In this section we will conduct analysis on second part of thesis objective. We have selected credit card product for KFH and NBK banks which are operating in Kuwait. For the DIB and SCB banks which are operating in Pakistan, we have selected house and car financing products. We will be using same specifications and criteria for selecting quotations for each product and then calculate net present value of the payments charged to the customers.

4.6.1 Analysis & findings of credit cards of KFH and NBK

Both banks offer credit cards and are regulated by Central Bank of Kuwait. For simplicity of analysis, we have chosen credit cards with same credit limit which is 5,000 Kuwaiti Dinar (KD). As KFH does not charge interest, it caters for the profit by charging annual subscription fee which is higher than other conventional banks. NBK charges a nominal annual subscription fee plus any interest on due amount. Below table shows the amount charged to customers starting from 500 KD till maximum limit consumption with increment of 500 KD. KFH charges yearly subscription fee of 400 KD and no interest on whatever amount utilized within the limit. NBK charges yearly subscription fee of 100 KD plus standard percentage of interest on due amount (which was 11%).

Table 4: Calculation of monthly installment of KFH & NBK with respect to amount utilized by card holder

Amount in KD		
Amount Utilized by Card Holder	Monthly Payment with KFH	Monthly Payment with NBK
500	75	54
1,000	117	100
1,500	158	146
2,000	200	192
2,500	242	238
3,000	283	284
3,500	325	329
4,000	367	375
4,500	408	421
5,000	450	467

*All figures rounded up and are in KD

Assuming annual percentage rate of 14%, the effective monthly rate is 1.098% (calculated based on below formula).

$$\text{Effective monthly rate} = (1 + \text{annual rate})^{(1/12)} - 1$$

Then we calculate the NPV of total monthly installment paid by customer to each bank.

Table 5: Calculation of NPV of monthly installments paid by customer to KFH

KFH	NPV of monthly installment at Month Number												Total
	1	2	3	4	5	6	7	8	9	10	11	12	
Monthly Payment (KD)	75	74	73	72	71	71	70	69	69	68	67	67	846
	117	115	114	113	111	110	109	108	107	106	105	104	1,319
	158	155	153	152	150	149	148	146	145	143	142	141	1,782
	200	196	194	192	190	189	187	185	183	181	180	178	2,256
	242	237	235	233	230	228	226	224	222	220	217	215	2,729
	283	278	275	272	270	267	264	262	259	257	254	252	3,192
	325	319	316	313	310	307	304	301	298	295	292	289	3,666
	367	360	356	353	350	346	343	339	336	333	330	326	4,139
	408	400	396	392	389	385	381	377	374	370	366	363	4,602
	450	441	437	433	429	424	420	416	412	408	404	400	5,076

*All figures rounded up and are in KD

Table 6: Calculation of NPV of monthly installments paid by customer to NBK

NBK	NPV of monthly installment at Month Number												Total
	1	2	3	4	5	6	7	8	9	10	11	12	
Monthly Payment (KD)	54	53	52	52	51	51	50	50	49	49	49	48	609
	100	98	97	96	95	94	93	92	92	91	90	89	1,128
	146	143	142	140	139	138	136	135	134	132	131	130	1,647
	192	188	186	185	183	181	179	178	176	174	172	171	2,165
	238	233	231	229	227	224	222	220	218	216	214	212	2,684
	284	279	276	273	270	268	265	263	260	258	255	253	3,203
	329	323	320	316	313	310	307	304	301	298	296	293	3,711
	375	368	364	361	357	354	350	347	343	340	337	334	4,230
	421	413	409	405	401	397	393	389	386	382	378	375	4,749
	467	458	454	449	445	440	436	432	428	424	419	415	5,267

*All figures rounded up and are in KD

Table 7: Comparison of credit cards of KFH & NBK

Amount Utilized	Monthly Payment for KFH	NPV of Yearly Payment for KFH	Monthly Payment for NBK	NPV of Yearly Payment for NBK	Cheaper	Savings with KFH (Yearly NPV Difference)	Savings with NBK (Yearly NPV Difference)
500	75	846	54	609	NBK	Loss	237
1,000	117	1,319	100	1,128	NBK	Loss	191
1,500	158	1,782	146	1,647	NBK	Loss	136
2,000	200	2,256	192	2,165	NBK	Loss	90
2,500	242	2,729	238	2,684	NBK	Loss	45
3,000	283	3,192	284	3,203	KFH	10	Loss
3,500	325	3,666	329	3,711	KFH	46	Loss
4,000	367	4,139	375	4,230	KFH	91	Loss
4,500	408	4,602	421	4,749	KFH	146	Loss
5,000	450	5,076	467	5,267	KFH	192	Loss

*All figures rounded up and are in KD

From the above table, it is clear that monthly payment charged by both banks is a function of different variables which are annual subscription fee (say A), interest charged on outstanding amount (i), total loan amount (L) and actual amount recovered monthly (R). Below are the generic functions for both the banks:

$$\text{Monthly payment for KFH} = A/12 + R$$

$$\text{Monthly payment for NBK} = A/12 + f(L,i) * + R$$

*f above indicates a function of loan amount and interest

It is evident from the table 7 and functions above that NBK (which is conventional bank) credit card is profitable for customers until the half credit limit consumption since there is a function of interest and interest will increase as amount increases. So hence for lesser amount, NBK is more profitable. On the other hand, KFH charges a fixed annual fee and hence it is profitable for those customers who are going to use almost full credit limit. Apart from the above figures, both banks offer promotions having discount on particular outlets although NBK has a better comprehensive reward program and it also offers free travel insurance for credit card holders.

4.6.2 Analysis & findings of house financing of DIB and SCB

Suppose a customer wants to avail house financing product. For simplicity, let's assume total cost of house is two million PKR and financing of one million PKR is required for tenure of three years. Below is the schedule of charges and quotation given by Dubai Islamic Bank (DIB)- Pakistan.

Table 8: Quotation specifications for house financing of DIB

Cost Price: (PKR)	2,000,000	Total Units	36
Customer Share: (PKR)	1,000,000	Unit Sale Price: (PKR)	27,778
Bank Share: (PKR)	1,000,000	Monthly Rent Per Unit: (PKR)	387

Table 9: Calculation of monthly payment paid by customer to DIB

Month Number	Rent (PKR)	Unit Price	Total Monthly Payment	Balance Unit Value
1	13,933	27,778	41,711	972,222
2	13,546	27,778	41,324	944,444
3	13,159	27,778	40,937	916,667
4	12,772	27,778	40,550	888,889
5	12,385	27,778	40,163	861,111
6	11,998	27,778	39,776	833,333
7	11,611	27,778	39,389	805,556
8	11,224	27,778	39,002	777,778
9	10,837	27,778	38,615	750,000
10	10,450	27,778	38,228	722,222
11	10,063	27,778	37,841	694,444
12	9,676	27,778	37,454	666,667

13	9,289	27,778	37,067	638,889
14	8,902	27,778	36,680	611,111
15	8,515	27,778	36,293	583,333
16	8,128	27,778	35,906	555,556
17	7,741	27,778	35,519	527,778
18	7,354	27,778	35,131	500,000
19	6,967	27,778	34,744	472,222
20	6,580	27,778	34,357	444,444
21	6,193	27,778	33,970	416,667
22	5,806	27,778	33,583	388,889
23	5,419	27,778	33,196	361,111
24	5,031	27,778	32,809	333,333
25	4,644	27,778	32,422	305,556
26	4,257	27,778	32,035	277,778
27	3,870	27,778	31,648	250,000
28	3,483	27,778	31,261	222,222
29	3,096	27,778	30,874	194,444
30	2,709	27,778	30,487	166,667
31	2,322	27,778	30,100	138,889
32	1,935	27,778	29,713	111,111
33	1,548	27,778	29,326	83,333
34	1,161	27,778	28,939	55,556
35	774	27,778	28,552	27,778
36	387	27,778	28,165	Zero
Total	257,765	1,000,008	1,257,767	

*All figures rounded up and are in PKR

If house financing product of Standard Chartered Bank (SCB)-Pakistan is availed for the same amount and tenure (i.e. one million financed for three years), then total monthly installment is PKR 36,156. This constant amount will be payable by customer for 36 months. However, the total monthly installment in Islamic bank DIB decreases each month as customer buy more and more shares. So the rent decreases by a fixed amount for each share bought in that particular month. However, both banks reserves the right to revise the interest rate and hence monthly payment based on KIBOR (Karachi Inter Bank Offer Rate). For simplicity we are assuming that payments will not be revised for the complete since it will almost effect both quotations with similar percentage.

Table 10: Quotation specification & calculation of monthly payment paid by customer to SCB

Cost Price: (PKR)	2,000,000	Total number of monthly installments	36
Customer Share: (PKR)	1,000,000	Tenure	3 years
Bank Share: (PKR)	1,000,000	Total Monthly Payment(PKR)	36,156

Now we calculate present value of future cash flows for each quotation. Assuming annual percentage rate of 10%, the effective monthly rate is 1.00797% (calculated based on below formula).

$$\text{Effective monthly rate} = (1 + \text{annual rate})^{(1/12)} - 1$$

Table 11: NPV of monthly payments paid by customer to DIB & SCB

Month Number	Monthly Payment DIB	NPV Monthly Payment DIB	Monthly Payment SCB	NPV Monthly Payment SCB
1	41,711	41,381	36,156	35,870
2	41,324	40,673	36,156	35,586
3	40,937	39,974	36,156	35,305
4	40,550	39,283	36,156	35,026
5	40,163	38,600	36,156	34,749
6	39,776	37,926	36,156	34,474
7	39,389	37,260	36,156	34,202
8	39,002	36,602	36,156	33,931
9	38,615	35,952	36,156	33,663
10	38,228	35,311	36,156	33,397
11	37,841	34,677	36,156	33,133
12	37,454	34,051	36,156	32,871
13	37,067	33,432	36,156	32,611
14	36,680	32,822	36,156	32,353
15	36,293	32,219	36,156	32,097
16	35,906	31,623	36,156	31,843
17	35,519	31,035	36,156	31,592
18	35,131	30,453	36,156	31,342
19	34,744	29,880	36,156	31,094
20	34,357	29,313	36,156	30,848
21	33,970	28,754	36,156	30,604
22	33,583	28,201	36,156	30,362
23	33,196	27,656	36,156	30,122
24	32,809	27,118	36,156	29,884

25	32,422	26,586	36,156	29,648
26	32,035	26,061	36,156	29,413
27	31,648	25,542	36,156	29,181
28	31,261	25,031	36,156	28,950
29	30,874	24,525	36,156	28,721
30	30,487	24,026	36,156	28,494
31	30,100	23,534	36,156	28,269
32	29,713	23,047	36,156	28,045
33	29,326	22,567	36,156	27,823
34	28,939	22,094	36,156	27,603
35	28,552	21,626	36,156	27,385
36	28,165	21,164	36,156	27,169
Total	1,257,767	1,099,998	1,301,616	1,127,659

*All figures rounded up and are in PKR

So the present value of all the monthly payments made by customer for DIB is 1.1 million PKR as compared to present of all the monthly payments made by customer for SCB which is 1.127 million PKR. Hence Dubai Islamic Bank (DIB) is cheaper for this scenario by 27,661 PKR. Also DIB offers flexibility to customers in term of early payment i.e. a customer can buy additional units and the rent will decrease in the proportional amount. The rent charged by DIB is dependent on number of units due by customer. Each month as customer buys a unit, rent amount (and hence total monthly installment) will decrease by fixed amount (which 387 PKR in our case). So if a customer buys four units in any month, the rent will decrease by 1548 PKR ($387 * 4$). This flexibility is not available with SCB and customer has to pay penalty on early payment (which is fixed percentage on the amount due).

4.6.3 Analysis & findings of car financing of DIB and SCB

Suppose a customer wants to avail automobile financing product. For simplicity, let's assume total cost of the automobile is 495,500 (around half million) PKR and customer is paying down payment of 20%. DIB uses Ijara as mode of transaction in which bank will rent out the car to customer and will receive monthly rental from customer. So in this case, DIB asks customer to submit some fixed percentage of cost as security (maximum is 50% and minimum is 15%). So depending on the initial security amount submitted, the rental will be calculated (the greater the security amount, the lessor is monthly rental amount and vice versa) . At the end of lease period, customer has option to buy the car against the initial security deposited or simply end the contract and return the vehicle to the bank. The bank will maintain the ownership throughout the lease agreement. In contrast, SCB gives loan to customers to purchase the car. The loan is paid by customer

in monthly installments with markup added. Each year has different percentage of markup added as shown in the analysis table.

For simplicity assume that customer takes a loan of 396,000 PKR from SCB financed over a period of 3 years (assuming 99,000 PKR already available with customer to add with the loan amount).

Table 12: Car financing quotation specifications

Cost Price: (PKR)	495,500	Tenure	36 months
Down payment/ security: (PKR)	99,000	Financing required (PKR)	396,000

Now we calculate present value of future cash flows for each quotation. Assuming annual percentage rate of 10%, the effective monthly rate is 1.00797% (calculated based on below formula).

$$\text{Effective monthly rate} = (1 + \text{annual rate})^{(1/12)} - 1$$

Table 13: NPV of monthly payments paid by customer to DIB & SCB

Month Number	Monthly Payment DIB	NPV Monthly Payment DIB	Monthly Payment SCB	NPV Monthly Payment SCB
1	15,950	15,824	16,368	16,239
2	15,950	15,699	16,368	16,110
3	15,950	15,575	16,368	15,983
4	15,950	15,451	16,368	15,856
5	15,950	15,329	16,368	15,731
6	15,950	15,208	16,368	15,607
7	15,950	15,088	16,368	15,483
8	15,950	14,969	16,368	15,361
9	15,950	14,850	16,368	15,239
10	15,950	14,733	16,368	15,119
11	15,950	14,616	16,368	14,999
12	15,950	14,501	16,368	14,881
13	15,950	14,386	16,265	14,670
14	15,950	14,272	16,265	14,554
15	15,950	14,159	16,265	14,439
16	15,950	14,047	16,265	14,325
17	15,950	13,936	16,265	14,212
18	15,950	13,826	16,265	14,099

19	15,950	13,717	16,265	13,988
20	15,950	13,608	16,265	13,877
21	15,950	13,501	16,265	13,767
22	15,950	13,394	16,265	13,659
23	15,950	13,288	16,265	13,551
24	15,950	13,183	16,265	13,443
25	15,950	13,079	14,515	11,902
26	15,950	12,975	14,515	11,808
27	15,950	12,873	14,515	11,715
28	15,950	12,771	14,515	11,622
29	15,950	12,670	14,515	11,530
30	15,950	12,570	14,515	11,439
31	15,950	12,471	14,515	11,349
32	15,950	12,372	14,515	11,259
33	15,950	12,274	14,515	11,170
34	15,950	12,177	14,515	11,081
35	15,950	12,081	14,515	10,994
36	15,950	11,985	14,515	10,907
Total	574,200	497,460	565,776	491,968

*All figures rounded up and are in PKR

From the above table, it is evident that SCB is cheaper to the customer since it has lower total NPV (481,968 PKR) as compared to DIB (497,460 PKR). We are not taking into account the insurance cost since it is applicable to both the banks as it is compulsion from State Bank of Pakistan (SBP) and each bank may have contract with different insurance/Takaful companies with slight change in the rate. But at the end, the cost is paid by customer. However, there is one advantage with DIB that in case of theft or total loss to the vehicle, customer does not have to pay monthly rental since ownership remains with the bank and bank cannot charge rent if the vehicle is not in use. Of course, the bank will recover the amount from insurance/Takaful. This is not the case with SCB where the risk of theft/total loss lies with the customer as customer is maintaining the ownership of the vehicle. In case of late payments, SCB will charge as per the defined interest rate. Whereas in case of late payment in DIB, a fixed amount will be charged and this amount will be donated to charity and bank will not take any part from it. This fixed amount is charged (although as charity) in order for customers to fulfill their commitments and to maintain a smooth cash flow for the banks.

SECTION 5

CONCLUSIONS AND IMPLICATIONS

5. Conclusions and Implications

The basic objective of our report was to analyze the interest free banking in terms of Shariah analysis of the products of the banks under study at the operational level by drawing a comparison between the theoretical knowledge of Islamic finance inferred from Islamic Jurisprudence and its practical implementation and to come up with the weak areas and figure out the deviations in the practices of the bank from the literature and theoretical knowledge. The literature we specifically consulted and benchmarked for our study was in the form of books named as “Introduction to Islamic Finance”, “Guide to Islamic banking” by Mufti Muhammad Taqi Usmani and Dr. Mufti Muhammad Imran Ashraf Usmani. The financial products of the Islamic banks are being engineered on the basis of Islamic modes permissible in the Shariah. So while applying these modes to the financial products, the basic conditions that validate those modes and the contracts made between the bank and the customer on the basis of those are required to be met to make the financial product Shariah compliant.

So keeping in view the above approach of analyzing the products of the banks, we took up the underlying modes one by one applicable to a specific product category and carried out our research on that to explore the differences between the practice and the theory. So our study lead towards the critical analysis of some of the lacunas and weaker areas found in the practices of the bank and reflect deviations from the theory. So based on our analysis we would highlight in the following the grey areas found in different products of the bank one by one:

Currently all the deposit accounts maintained by the bank (KFH) are Mudaraba based contracts made with the depositors. After performing analysis on the Mudaraba arrangement, we found that few conditions of Mudaraba are being violated while practicing the Islamic mode of finance for deposit accounts. Eminent contemporary scholars have also commented upon these issues. The condition of Mudaraba that both parties must agree to a predetermined ratio of profit that is clearly known them is not complied properly; rather the profit proportion is decided in an ambiguous manner in a way that clients or depositors did not know the exact proportion of profit before the start of the Mudaraba. Secondly bank (KFH) is charging Mudarib fee in addition to its share in the earned profits. This practice also negates the necessary condition of Mudaraba that Mudarib’s share is only in the profit that are realized through Mudaraba business and it cannot deduct any administrative costs from the clients. The withdrawal

facility provided by bank in its saving accounts also violates the condition of Mudaraba that states that owner cannot interfere in the capital of Mudaraba, otherwise Mudaraba contract invalidates.

Murabaha financing applicable to export, import and working capital financing, We have found in the banking practice that the bank (KFH) in some situations is giving discounts to its customers for early payment of the debt which strictly violates the condition of Credit Murabaha where the price once settled can't be changed in the form of discount for early payment or premium on late payment from the Shariah perspective. So this activity weakens the credibility of the Shariah compliance of those products and related transactions for which the discount is made for early payments.

Another product of the bank i.e. export refinancing is found as an area which resembles the conventional refinancing to a significant extent and the content of both the products is similar to each other. In the later the exchange of bill is discounted by the bank while refinancing the customer and the Islamic bank is not discounting the receivables for refinancing but charging a fee over that in terms of providing a financial service to the customer. Both are very similar to each other and due to that this service charge of the bank becomes questionable from Shariah perspective as it is being charged on a debt.

After this let us move on the weaker areas found in practicing the Ijarah mode of financing. As the essence of the Ijarah contract is that the Lessor charges a rent from the lessee for the usufruct of the asset delivered to the later by the former and in case the usufruct is lost due to some factors beyond the control of the lessee than the lessee has an incentive get the rent exempted for that particular time period. But in actual practice bank (lessor) while undergoing an agreement with the client (lessee) does not inform the lessee about this incentive and therefore no claims regarding that are intimated to the bank and served accordingly even if some customer has faced a situation like that. So this unethical practice by the bank (DIB) weakens the Shariah credibility of the whole product of Ijarah financing. This practice is also observed in case of the Diminishing Musharaka where the same arrangement is undertaken between the two parties while leasing out the share of the bank in the joint property to the partner on rent. One important factor is required to be added up here is that in the lease agreement the owner ship of the asset remains with the lessor and accordingly he is liable to the risk attached with the asset. The lessor is covering the risk on the asset through Takaful and should solely bear the cost of that risk cover but implicitly while determining the rental payment of the asset that cost is passed on to the customer at the end of the day which again brings in controversy in the legitimacy of the act from Shariah perspective.

Though the act is not explicit but even done at the implicit level weakens the validity of the lease contract.

So these are the basic factors on the basis of which the knowledge from the Islamic jurisprudence differentiate the Islamic financial products from the conventional counterparts and if even these basic differences are not maintained then a lot of suspicion is created in the eyes of the people who are already confused about the reality of the Islamic financial products and do not find significant differences in practical terms to accept that Islamic banking is different from the conventional banking. Failure to abide by the basic conditions of the Islamic finance theory that should have been translated in to actual practice is the biggest reason for this existent perception of the people. Beside this, negligence on the part of implementation also builds up wrong notions about the theoretical aspects of the field which if had been adopted in true spirit would have presented a completely different picture of the Islamic Financial infrastructure.

REFERENCES

1. Ansari, Omar Mustafa & Memo, Faizan Ahmed (2008), 'Islamic Banking: Is it really "Islamic"?' Islamic Finance news, 5, 24-27
2. Bashir, Abdel H. (1998), Ethical norms and enforcement mechanism in profit-sharing arrangements.
3. Chong and Liu (2007), Islamic banking: Interest-free or interest-based, Pacific-Basin Finance Journal 17
4. Choudhury and Hussain (2005), "A paradigm of Islamic money and banking", International Journal of Social Economics
5. H.A. Dar and John R. Presley (1999), 'Lack of profit loss sharing in Islamic banking: management and control imbalances', international journal of Islamic financial services
6. Haniffa, Roszaini (2007), Exploring the Ethical Identity of Islamic Banks via Communication in Annual Reports.
7. Hanif, Muhammad (2011), "Differences and Similarities in Islamic and Conventional Banking" published in International Journal of Business and Social Science Vol. 2 No. 2
8. I. Ahmad, G.Shabbir (2003), FAQs on Islamic Banking, published by Islamic banking department State bank of Pakistan
9. I.A.Usmani (2002), Guide to Islamic banking, Darul Ishaat Karachi.
10. Iqbal and Mirakhor (1999), "Progress and Challenges of Islamic Banking", Thunderbird International Business Review
11. Ismail, Dr. Muhammad Nazari (2009), "Is the concept of Islamic banking in line with Islam?" Faculty of Business and Accountancy, Universiti Malaya.
12. Iqbal, Munawar & Llewellyn, David T (2002) "Islamic banking and finance: new perspectives on profit sharing and risk" ISBN-10 : 1840647876
13. Jan, Hameedullah Head Mufti Jamia Ashrafia Lahore (2007) , 'Islamic Banking in the light of Shariah', published in Al-Ahsan Magazine Dar-ul-Tasneef
14. Khair Baksh (2008), Explaining the Islamic Banking System
15. Khalid Nainar, S.M. (1993), Business and Accounting Ethics in Islam.
16. Khan (1986), Islamic interest-free banking. IMF Staff Papers 33
17. Khan, M. Mansoor (2008) , Main features of the interest-free banking movement in Pakistan , Managerial Finance Vol. 34 No. 9
18. Khan, Mufti Zarwali (2011), Book "Ahsan-ul-Kitab" vol 2, published by Jamia Arabia Ahsan-ul-Uloom
19. Malik, Muhammad Shaukat; Malik, Ali & Mustafa, Waqas (2011), "Controversies that make Islamic banking controversial: An analysis of issues and challenges" published in American journal of social and management sciences ISSN Print: 2156-1540
20. Martin Lewison (1999), Conflicts of Interest? The Ethics of Usury
21. Mehboob ul Hassan (2006), "People's perception about Islamic banking in Pakistan", Ph.D thesis submitted to Nagoya state university
22. M. K. Hassan, M.K. Lewis (2007), Handbook of Islamic banking, Edward Elgar Publication.
23. M. Iqbal, A. Ahmad, T. Khan (1998), 'Challenges facing Islamic finance', Islamic development bank and Islamic research and training institute. Ijlal Alvi (2006), 'Third annual Asian Islamic banking and finance summit' Pakistan.
24. Muhammad Ayub (2008), Understanding Islamic Finance (The Wiley Finance Series)
25. 'Mutaffiqqa Fatwa' (2008) , Current Practices of Islamic Banking Institutions, published in Al-Ahsan Magazine Dar-ul-Tasneef

26. Penelope Phoon (2004), Islamic banking is where ethics reigns, article published in Business Times
27. Pramanik, Ataul Haq (2005), "Islamic Banking How Far Have We Gone", First edition ISBN 983-2957-42-7
28. Rafik I. Beekun (2005), Balancing Ethical Responsibility among Multiple Organizational Stakeholders: The Islamic Perspective
29. State Bank of Pakistan publication (2007), Process for standardization of Shariah practices
30. State Bank of Pakistan – Islamic Banking Department (2008), "Instructions for Shariah Compliance in Islamic Banking Institution" Annexure 1 of IBD Circular No: 02 of 2008
31. State Bank of Pakistan Annual reports (<http://www.sbp.org.pk/reports/annual/index.htm>)
32. T. Usmani (2005), The Historical Judgment on Interest, delivered to the Supreme Court of Pakistan, Published in 2000, Idaratul-Ma'arif ul Quran, Darul Ishaat (Karachi)
33. Usmani, Muhammad T. (1999), 'An Introduction to Islamic Finance', 1st ed. Karachi: Idaratul Ma'Arif
34. Usmani, Dr. Imran Ashraf (2002), "Guide to Islamic Banking : An overview of the fundamentals of Islamic Banking" published by Darul – Ishaat Urdu Bazar Karachi Pakistan, ISBN 969-428-006-0
35. Usmani, Dr. Imran Ashraf (2002), "Meezan Bank's Guide to Islamic Banking"
36. Usmani, Mufti Muhammad Taqi (1999), "An Introduction to Islamic Finance" Published by Idara Isha'at-e-Diniyat (PVT) Ltd. New Delhi-India ISBN 8171012361

WEBSITE REFERENCES

www.Albaraka.com.pk
www.barakaonline.com/default.asp
www.cbk.gov.kw/PDF/book6Eng/sub2.pdf
www.dibpak.com/Default.aspx
www.ifresource.com/Shariah-specialists-in-islamic-finance
www.islamic-banking.com/profit_and_lose_sharing.aspx
www.islamicbankers.wordpress.com/islamic-banking-contracts-and-concepts/glossary-of-terms
www.kfh.com/en
www.investopedia.com/articles/03/101503.asp#axzz1f5h5KJRZ
www.kuwait.nbk.com
www.meezanbank.com
www.muftitaqiusmani.com
www.meezanbank.com
www.sbp.org.pk/press/essentials/Essentials%20of%20Islamic.htm
www.sbp.org.pk
www.standardchartered.com/pk

APPENDIX A
GLOSSARY

Keyword	Meaning
Riba	Interest
Shariah	Law of Islam
Murabaha	Cost-plus sale
Mudaraba	Profit Sharing
Mudarib	Entrepreneur, in a Mudaraba transaction
Ijara	Rent
Musharaka	Joint venture partnership
KIBOR	Karachi Inter Bank Offer Rate (Average interest rate in Pakistan at which term deposits offered in wholesale)
LIBOR	Lahore Inter Bank Offer Rate
DIB	Dubai Islamic Bank (An Islamic bank in Pakistan)
KFH	Kuwait Finance House (An Islamic bank in Kuwait)
NBK	National Bank of Kuwait (A leading conventional bank in Kuwait)
SCB	Standard Chartered Bank (A leading conventional bank in Pakistan)
Fiqh	The science of Shariah
Rabul Mall	Capital providers, Fund owner
Takaful	Mutual assistance
KD	Kuwaiti Dinar (1 Euro= 0.368 KD)
PKR	Pakistani Rupees (1 Euro = 117 PKR)
NPV	Net Present Value

APPENDIX B

AN OVERVIEW OF ISLAMIC BANKING

1. Interest (Riba) definition

As described in previous section the main difference between Islamic banking and conventional banking is the prohibition of interest (also called *Riba* in Arabic) in Islam that can never be used as a financial instrument in any case or mode of finance. Therefore it is important to explain Riba and its types before proceeding further. Riba is an instrument that is strictly forbidden in Islamic Shariah. There are obvious versus in sacred books of Islam. Further different types of Riba were defined explained by Jurists in with books of Islamic jurisprudence. Few versus in Quran which is the most Holy book in Islam are stated below:

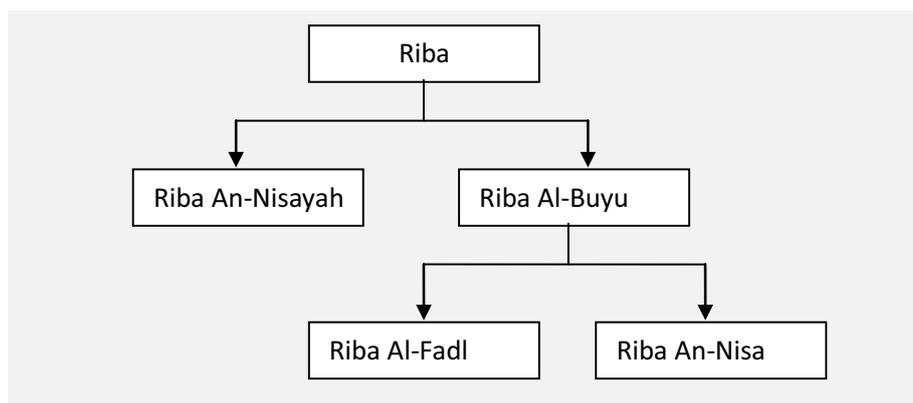
- 2 "O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy." (*Chapter 3, verses 130-2*)
- 3 "Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist may keep their previous gains, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein forever." *Fourth Revelation (Chapter 2, verse 275)*

The word "Riba" means excess, increase or addition, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (*I.A Usmani, 2002*) Mufti Taqi Usmani in his famous writing (*Usmani, 2000*) has explained the term Riba with reference to the great imam and jurist Imam Abu Bakar Jassas (Died 380 A.H) as; "And the *Riba* which was known to and practiced by the Arabs was that they used to advance loan in the form of Dirham (silver coin) or Dinar (gold coin) for a certain term with an agreed increase on the amount of the principal advanced". The same jurist (Imam Abu Bakar Jassas) clarifies the type of Riba common at the days of Prophet (Peace be upon Him) as, "The Riba of Jahiliyya (before Islam) is a loan given for stipulated period with a stipulated increase on the principal payable by the loanee".

2. Explanation of Riba and its types in Islamic Shariah

Riba that is described and explained in sayings of Prophet Mohammad (peace be upon him) is categorized into two forms by the contemporary scholars. State bank of Pakistan Shariah board defines these two types as Riba An-Nasiyah and Riba Al-Fadl (Ahmad, Shabbir, 2002). Similarly Mufti Imran Ashraf Usmani and Mufti Taqi Usmani also classified Riba in these two forms i.e. An-Nasiyah and Al-Fadl. Another name used for Riba An-Nasiyah is Riba Al-Quran (I.A Usmani, 2002). M. Kabir Hassan in his handbook of Islamic banking categorized Riba into two broad classes as Riba An-Nasiyah (which he also termed as Riba Al-Qarud) and Riba Al-Buyu, and further classified Riba Al-Buyu into two types Riba Al-Fadl and Riba An-Nisa with marginal difference between the two. (Hassan, Lewi 2007). So after consolidating both views we classify and define Riba in this way;

Figure 1: Different Types of Riba



2.1 Riba An-Nasiyah/Riba Al-Qurad/Riba Al-Quran

The type of Riba involves a charge on a loan arising with the passage of time. In other words this is simply a loan at interest. It arises where a user of another's wealth, in any form, is contracted by the other to pay a specified increase in addition to the principal amount in repayment (Hassan, 2007). 'Riba An Nasiyah' is defined as excess, which results from predetermined interest which a lender receives over and above the principle amount. This is the type of Riba which is explicitly prohibited in Quranic versus and Mufti Imran Ashraf Usmani in his Guide to Islamic banking says that, "The prohibition of Riba An Nasiyah is one of those issues which have been confirmed in the revealed laws of all Prophets (AS)". And he further says that, "The fact that Riba An-Nasiyah (a form of interest meaning excess of delay) is categorically prohibited has never been disputed in the Muslim community" i.e. the giving and taking of any excess amount in exchange of a loan at an agreed rate irrespective whether at a high or low

rate³⁵. This is obvious from the above definitions that today's conventional banks are involving in this type of Riba (interest) i.e. Riba An-Nasiyah from both financing and investment side.

2.2. Riba Al-Buyu

Riba Al-Buyu classifies the type of Riba that is involved in trade and is forbidden in books of Hadith. It is further categorized into two classes as:

2.2.1. Riba Al-Fadl

Riba Al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase & sale (*Usmani, 2002*). And Kabir Hassan described it as a transaction that involves an exchange of unequal qualities or quantities of the same commodity simultaneously. Famous saying of Prophet Muhammad (Peace Be Upon Him) forbidding Riba Al-Fadl is (*I.A Usmani, 2002*):

“The Prophet Muhammad (Peace Be Upon Him), said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (Riba). However, sell gold for silver anyway you please on the condition it is hand-to-hand (spot) and sell barley for date anyway you please on the condition it is hand-to-hand (spot).”

2.2.2. Riba An-Nisa

Riba An-nisa is similar to Riba Al-Fadl except that it involves the non-simultaneous exchange of equal qualities and quantities of the same commodity rather than simultaneous exchange (*Hassan 2007,*)

3. Modes of Islamic finance

There are two types of Islamic financing modes used for designing the financial products and form the basis for underlying mechanism used to develop and build up a product and further improvements required with the passage of time. Following is the over view of these two different modes (Essentials for Islamic modes of finance, SBP publication 2003)

- (i) Participatory modes
- (ii) Non-participatory modes

Participatory Modes

Mudaraba and Musharka mode of financing are also considered as participatory modes of finance. These modes belong to high risk category. The mechanism of these modes is described as follow:

3.1 Mudaraba

This implies a contract between two parties, the financier and manager, whereby the financier entrusts money to the manager for a venture and they divide the profit generated in a pre-agreed ratio. The manager utilizes the money in an agreed manner and returns to the financier the principal and his pre-agreed share of profit.

Under Mudaraba, an Islamic bank provides financing to a client for a particular venture hence maintaining the position of financier while the client acts as manager. The resulting profits and losses from the venture are shared according to the rules of Mudaraba. For example, an Islamic bank might provide USD 100,000 to a client to finance expansion of factory; in return the Islamic bank will get 20% of the factory's net profits every year for a period of 5 years and get its principal back after the designated period. The share of the profits earned by the Islamic bank from this venture provides for repayment of the principal and profit to pass on to its investment account holders. If the factory loses money, the Islamic bank, its investment account holders and the borrower all jointly absorb the losses, thereby putting into practice the pivotal Islamic principle that the providers and users of capital should share risks and rewards (Usmani, 2002)

3.2 Musharaka

This is a partnership formed to carry out a specific project, normally of limited duration, with capital contributed by both partners. Profits are divided on a pre-determined basis, and losses, if any, are shared in proportion to the capital contribution by each partner. Under such an arrangement, the Islamic bank enters into a partnership with a client and shares the equity capital (and perhaps even the management) of a project or deal. Both partners share in profits according to a pre-agreed ratio and losses according to the proportion of their respective equity shareholdings. Banks can use the Musharaka instrument for working capital financing, project financing, trade financing and for other types of single transactions (Usmani, 2002)

Non-Participatory Modes

The modes belonging to low risk category, like trade and lease based modes that may generate fixed returns, are treated as non-participatory modes of financing. These modes are briefly discussed hereunder:

3.3 Murabaha

This is the sale of a commodity at a price which includes a stated profit known to both the vendor and the purchaser. This can be called a cost plus profit contract. Under Murabaha, the Islamic bank purchases, in its own name, goods that an importer needs, and then sells those goods to the importer at an agreed price, composed of cost plus profit. This technique is usually used for financing trade, but because the Islamic bank takes title to the goods, and is therefore, engaged in buying and selling, its profit derives from a real service that entails a certain risk, and is thus seen as legitimate. It is important to note that only a legitimate profit in addition to the actual price is considered lawful under Islamic law. (Usmani, 2002)

3.3.1 Credit Murabaha

The difference between simple Murabaha and the credit Murabaha is that the former is simply a sale for a cash payment but the latter one is the deal on the basis of delayed payments. The delayed payments are actually the loan or mortgage which a buyer is bound to pay either in either in a lump sum amount or in installments whatever is agreed between the two parties. A sale is made on a cost-plus concept means that the bank discloses its cost to the client and then charges a profit over that cost. The role of credit Murabaha comes in to play when the bank and the customer negotiate the terms and conditions of the deferred payment which are very crucial and important to realize from Shariah stand point. These stipulations in the contract make the sale of a commodity or transaction Shariah fit.

3.4 Salam

In a Salam contract a buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed spot price. This financing technique, similar to a forward-purchase contract, is particularly applicable to seasonal agricultural purchases. Salam can be used as a means of financing production. Here the price is paid at the time of the contract but the delivery would take place at a future

date. This mode enables an entrepreneur to sell his output to the Islamic bank at a price determined in advance. Hence manufacturer/seller in need of financing can sell his future production to the Islamic bank at spot price and deliver the goods later. The Islamic banks use a Parallel Salam arrangement and sell the goods purchased through Salam to a third party in order to earn profit. At the time of sale all specifications, quality and quantity of the commodity must be determined to avoid any ambiguity which could become a cause of dispute. Furthermore, date and time of delivery must also be agreed upon but can be changed with mutual consent of the parties (Usmani, 2002).

3.5 Istisna'a

Istisna'a, like Salam, is a special kind of sale where sale of a commodity is transacted before it comes into existence. It is an agreement concluding into a sale at an agreed price whereby the purchaser places an order to manufacture, assemble or construct, or cause so to do, anything to be delivered at a future date. Istisna'a can be used for providing financing for the construction of houses, plants, projects, building of bridges, roads and highways, etc. Under such an arrangement an Islamic bank acts as an intermediary in financing the manufacture of the required commodity for the client through a contractor. The Islamic bank pays the contractor for the asset to be manufactured and delivers the asset to the client at the due date receiving payment as per agreed mode (Usmani, 2002).

3.6 Ijara

Ijara is a rental agreement in which the lessor gives the asset to the lessee for usage and charges regular rent for it. The ownership of the leased commodity remains with the lessor and only right for benefitting the use of it is shifted to the lessee. Anything which cannot be utilized unless absorbing and devouring same, cannot be leased out like money, eatables, fuel, etc. Ijara is a rental agreement between the Islamic bank and the customer. It is a relatively long term financing arrangement. Under Ijara, the Islamic bank retains the ownership of the assets and gives the possession and use of the asset to the customer in return for payment of specified rental over a given period of time. After the maturity of the lease contract, the Islamic bank may maintain possession of the asset for further leasing or sell it to a lessee under a separate sale contract. (Hassan, 2007).

3.7 Tawarruq

Islamic banks use Tawarruq transaction as a mode of short term financing. This product is to cover the customer's need of cash through the mechanism of trade. Tawarruq is buying goods on credit and selling it to a buyer other than the seller for a spot price to get the cash. The Islamic bank carries out the transaction by buying a particular commodity from a vendor and selling it to the client on deferred payment at cost plus profit. The client satisfies his current financing requirement by selling the commodity in the market at spot price (Hassan, 2007)

APPENDIX C

SURVEY QUESTIONS

These survey questions will be asked to concerned representative of Islamic banks under study which are Kuwait Finance House (KFH) and Dubai Islamic Bank (DIB). It is based on Likert scale 0-10 with disagreement on left side (0 being the most disagreement) and agreement on right side (10 being the most agreement). These questions will be asked in English only since this is common language between authors and the bank's representatives. All of these survey questions are related to different Islamic banking products under study and will help in determining compliance with the standards. Below table shows summary of hypothesis connected to each survey question.

High level hypothesis tested	Question Numbers
Mudaraba pool management	1,2,4,7
Profit determination in Mudaraba	3,5,6,8-12
General conditions of Mudaraba	13-19
Murabaha price settlement	20-23
Ijara asset management	26-28

1. Does your bank maintain separate pools of equity for each account type?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

2. Regarding the nature of income of the client at the time of making a Mudaraba agreement, is bank concerned and takes into consideration illegal sources of income?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

3. Does bank make any promised returns to its customers or any minimum amount of return of investment to its clients?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

4. To what extent partnership in the Mudaraba pool is created with the consent of the clients/depositors?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

5. Each client knows the exact proportion of profit he is going to receive?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

6. Profit distribution mechanism is devised by the Shariah advisory board of the banks rather than standard formulated by some regulatory authority?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

7. Certain account types reserves the right to withdraw money at their choice from the accounts, even if the Mudaraba arrangement is going on?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

8. Bank reports the loss in Mudaraba to its depositors?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

9. Reporting the loss to the depositors has negative effects on customer satisfaction and retention?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

10. According to the condition of Mudaraba, the loss (if incurred) is solely tolerated by the Rabb-ul-Mal, does the Mudaraba arrangement made by bank abide by this condition?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

11. Does bank decreases its own share in favor of the client to compensate for the loss/decrement?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

12. If bank decreases its own share in favor of client, does not it makes an illusion for guaranteed returns to its customers?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

13. Do the issue related to 'Time of value of money' is considered for different term deposits?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

14. Are weight ages used as a replacement for 'pre-determined profit ratio' condition that must be known to both parties before the start of the Mudaraba?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

15. Are clients concerned about this fact that where their funds are invested?

Not interested					Neutral	Seriously Interested				
0	1	2	3	4	5	6	7	8	9	10

16. Do they invest in the equity market through buying stocks of different companies?

Different portfolio					Neutral	Same portfolio				
0	1	2	3	4	5	6	7	8	9	10

17. Is there any minimum level of debt in the capital structure of the target companies set by the bank?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

18. To what extent bank provides money to Entrepreneurs for starting SMEs (small and medium sized enterprises)?

Not at all					Neutral	Very often				
0	1	2	3	4	5	6	7	8	9	10

19. Is tying up the profits with the KIBOR (Karachi Inter Bank Offer Rate) as a reference point similar to an interest bearing form of transaction?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

20. Price once settled in the credit Murabaha can change later at the end of contract or during the contract?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

21. Bank charges any premium amount in case of late payments over the settled price as a financial penalty?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

22. Bank gives discount to customers for early payments?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

23. Post-shipment export refinancing is similar to or very closer to conventional refinancing mechanism?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

24. Charging a fee on the provision of interest free loan is very much similar to interest bearing loan and the financial back up provided on discount terms?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

25. If Islamic Interbank offer rate (IIBOR) is implemented, would it be able to revive the negative image of Islamic banks created due to tying up with the KIBOR (Karachi Interbank Offer Rate)?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

26. Bank charges the client in case the usufruct of the asset is lost due to some factors beyond the control of the client?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

27. Are the clients informed about the incentive of rental waiving off in case of lost usufruct of the asset due to factors beyond the control of the client?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

28. If there is a delay in the delivery of the vehicle to the customer at the start of the lease then whether the customer is charged during that time period?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

29. Clients are more concerned about the Shariah compliance and interest free aspect of the deposit accounts rather than profits?

Strongly Disagree					Neutral	Strongly Agree				
0	1	2	3	4	5	6	7	8	9	10

APPENDIX D

INDEPTH INTERVIEW QUESTIONS

These are in depth interview questions which will be asked to the concerned Islamic bank's representatives. These questions are optional to answer but will help greatly in determining the compliance.

1. How much is the average variation in the profits for different account types and what is the current profit distribution proportion for Mudaraba arrangement between bank and the depositors?
2. How frequently the proportion of ratio is changed and to what extent?
3. How you satisfy the main condition of `predetermined profit distribution proportion` in the beginning of the Mudaraba agreement?
4. How `beginning` and `end` of Mudaraba is recognized in the current situation, because not all of the depositors deposit money at the same time, nor they keep money with the bank for the same period of time?
5. How bank manages profit distribution in a running business, in which clients are entering and leaving, depositing and withdrawing?
6. How bank justifies the deduction of administrative costs (if any) from the realized profit?
7. What are the criteria for selecting the company for equity investment?
8. What steps are being taken by the bank to eliminate Interest (Riba) and other prohibited elements like gambling by the Shariah from its financial system?
9. To what extent bank assumes a role of commercial intermediation apart from its specific major role of financial intermediation?
10. How does the bank secure the extended credit facility given in the form of credit sale to the customer?
11. For how long bank bears the risk on commodity or asset before selling it to the customer?
12. How the daily product method used in conventional banks (for distribution of fixed interest) is differentiated from that used in Islamic banks (for distribution of profits)?

Below mentioned interview questions which will be asked to the Shariah Advisory Board members. These questions are also optional to answer but will help greatly in determining the compliance.

13. How the incorporation of the concept of `time value of money` is justified in light of Shariah?
14. What is the Shariah legitimacy of determining a minimum level of debt in the structure of a company?
15. How is the profit determined on the credit sale by the bank to the customer?
16. What is the time duration between the delivery of the commodity to the agent and actual sale to the client?
17. How is the repayment schedule made in terms of time frame?
18. What is the difference between the conventional operating lease and Ijara lease?
19. What kind of authority is delegated to the client after undertaking the agency agreement?