



الجامعة الإسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
بِوَسِيْلَتِيْ اِسْلَامِيْ اَنْبِيَا رَا اِيْجِيْنَا مَلِيْئِيْنَا

KULLIYAH OF LAWS

ISLAMIC BANKING - A COMPARATIVE APPROACH
A Case Study of IRAN, MALAYSIA, PAKISTAN and SUDAN
with special reference to
“Musharaka” and “Modaraba” Financing

By:

IFTIKHAR AHMAD

Submitted in Partial Fulfilment of the Requirements
for
Master of Comparative Laws

Session 1993 / 94

340625

41

INTERNATIONAL ISLAMIC UNIVERSITY LIBRARY
No: 340631 (c)
Date: 28 - 9 - 94

t
HG
3368
A6
I23I
1994

DEDICATION

To my mother who gave me care,
and compassion and endless love
throughout my life;
and to my father who sacrificed everything
to show me the light of the day

MOTTO:

هَقْل رِب زَنِي عِلْمَا

Meaning: "O My Lord! advance me in Knowledge."

[Taha: 114]

DISSERTATION

This dissertation is a partial requirement of
Master of Comparative Laws (MCL),
submitted to the Kulliyah of Law,
IIU, Malaysia

Supervisor:

Assoc. Prof. Dr. Sabri Salmon

By:

IFTIKHAR AHMAD

Session 1993/94

Examination Committee

SIGNATURE:

(Supervisor)

Name: Assoc. Prof. Dr. Sabri Salmon

Date :

KULLIYAH OF LAWS

SIGNATURE:

(Dean Kulliyah of Laws)

Name: Tan Sri Dato' Prof. Ahmad Ibrahim

Date :

ACKNOWLEDGEMENT

Praise be to Allah S.W.T. who gave me the opportunity to continue my study in this institution of high repute.

First of all I wish to express my hearty gratitude and thanks to my supervisor, Assoc. Prof. Dr. Sabri Salmon who always made himself available to me for every appointment without missing even a single one and offered me the needed and useful advice and assistance without which I would not have been able to complete this work.

I am also very much indebted to Assist. Prof. Dr. M. Anwar who supplied me with some useful materials. However, any fault whatsoever, either in form or substance is entirely my responsibility. I would also like to thank my beloved parents. Without their invaluable prayers, continuous encouragement and moral support, this work would not have been possible. Last but not least, I am indebted to Sister Liza for typing my thesis, and to all my sincere friends for their consistent support and encouragement through out this study. To all of them I say "Thank you very much" and "Terima Kasih".

Thank you very much. (Terima Kasih)

May Allah S.W.T. reward them all with the best of rewards in this world and Hereafter....!

TABLE OF CONTENTS

	PAGE
ACKNOWLEDGEMENT	vi
TABLE OF CONTENTS	vii

CHAPTER NO. ONE**INTRODUCTION**

CONTENTS:	1
Aims of Islamic Economic	4
Islamic Banking in Iran	5
Islamic Banking in Malaysia	6
Legal Framework : Islamic Banking Act 1983	7
Incorporation of the Bank	9
Islamic Banking in Pakistan	9
Islamic Banking in Sudan	10

CHAPTER NO. TWO

<u>BANKING IN GENERAL</u>	15
----------------------------------	----

CONTENTS:	
Origin and nature of Banking	15
History and development of Banking	16
Beginning of Modern Banking	16
Functions of Modern Banks	18
Classification of Modern Banks	19

Bank of England	21
Unit Banking System of U.S.A.	22
Banking in former U.S.S.R.	22
Commercial banks and their function	23
The World Bank.	25

CHAPTER NO. THREE

<u>THE RISE OF ISLAMIC BANKING</u>	30
------------------------------------	----

CONTENTS:

Historical background of Islamic Banking	32
Classification of Islamic Banking	34
Business practices of Islamic Banks	35
The Social scope Islamic Banks	40
Permissible Forms of transactions in Islamic Banking	42
A model of Islamic Banking	44

CHAPTER NO. FOUR

<u>DOCTRINE OF AL MUSHARAKA (PARTNERSHIP)</u>	50
---	----

CONTENTS:

Musharaka	51
Validity of Musharaka	51
Types of Musharaka	52
Division of Modern Musharaka (Partnership Contract)	52
Condition of Musharaka	53

Condition for Modern Musharaka (Partnership Contract)	55
✓Musharaka (Civil Partnership) under interest free banking law of Iran	56
✓ Special characteristics of Musharaka (Civil Partnership) in Iran	57
✓ Musharaka financing in Malaysia	67
✓ Sources of funds for Al Musharaka (Partnership)	67
✓ Financing	69
✓Musharaka (Partnership) financing in Pakistan	72
✓ Necessary amendments in existing laws for Musharaka financing in Pakistan	73
Partnership Act (1932) Amendments	75
✓Musharaka as used in commercial Bank of Pakistan	76
Musharaka Financing a Sudanese Experience	79
Procedure for Musharaka Financing under (SIB)	79
Musharaka in Trade	80
Musharaka in Agriculture Investment	81
Musharaka in Industrial Investment	82
Musharaka under Islamic Solidarity Bank of Sudan	83

CHAPTER NO. FIVE

<u>DOCTRINE OF AL MODARABA (PARTNERSHIP)</u>	89
--	----

CONTENTS:

Al Modaraba	90
Kinds of Modaraba	95
The legal position of the Mudarib in the Mudarabah contract	96

Duration of the Mudarabah contract	98
Expire of the Mudarabah contract	99
Effect of Mudarabah contract upon Islamic Banks' Investment	100
✓ Modaraba Laws in Malaysia	101
✓ Primary Features	103
✓ Customers' Deposits in special Investment Accounts (Contract : Al Mudarabah / Trustee Profit Sharing	106
✓ Project Financing (Contract : Al Mudarabah / Trustee Profit Sharing	106
✓ Modaraba Laws in Iran	107
✓ Terms of Operation of Modaraba in Islamic Republic of Iran	109
✓ Basic factors that are considered as necessary for a Modaraba Transaction	109
✓ Operation of Modaraba contract	112
✓ Modaraba laws in Pakistan	114
✓ Conditions for Modaraba companies	117
✓ Floatation of first Modaraba in Pakistan	119
Modaraba in Sudan	122
Application of Modaraba in Banks	124
RECOMMENDATION	131
CONCLUSION	132
BIBLIOGRAPHY	135
APPENDIX	140

CHAPTER NO. ONE

INTRODUCTION

CONTENTS:

1. Aims of Islamic Economic
2. Islamic Banking in Iran
3. Islamic Banking in Malaysia
4. Legal Framework :
Islamic Banking Act 1983
5. Incorporation of the Bank
6. Islamic Banking in Pakistan
7. Islamic Banking in Sudan

In The Name of Allah the Compassionate and Merciful

INTRODUCTION

The economic order in the present world is based on injustice, exploitation, aggression, oppression, discrimination, corruption, plunder, and poverty.

The gap between the haves and the have - nots is getting wider and wider.

What is the answer? Communism? Capitalism? The first one didn't work and the second one is not working either. Both systems brought tension and conflict into their societies and finally, they are both facing failure.

All of us saw the collapse of communism with our own eyes.

These philosophies failed because of their inability to deal with life as a whole.

Marxism believed that all the manifestations of social life, including religion, ideology, politics, class, conflicts, social struggles, even philosophy, knowledge, role of individuals, and their psychological make-up _____ all _____ are reflections of economic conditions. According to Marxism, the main cause of any social change was change in mode of productive forces and the means of production.

The main mistake of Marxism was their idea that man lives by bread alone.

As a result of this erroneous premise, the Marxist ideology placed everything, even man's ideas and his thinking, within the materialistic framework.

Because their ideas were not realistic, frustration resulted. Slogans of socialism, nationalization, absolute equality, and "from everyone according to his ability to everyone according to this need" were never come into fact.

Seventy years of suppression, dictatorship, wiping out private ownership, elimination of all political authority (except that of the dictator, even ____ finally ____ the liberalization of society in recent months failed because all of these attempts were against human nature.

Explosion of "perestroika" and "glasnost" in the Soviet Union by Gorbachev was a response to the disastrous consequence of marxist ideology. Now, in Russia, everybody talks about another revolution, about democratization, openness, freedom of choice. The same party that believed that religion was the opiate of the people now opens the mosques and the churches and declares that "spirituality is a big element in the development of the country".

Now , let us have a brief look at the fate of capitalism.

No one can deny the crises and troubles of capitalism. This type of economy is based on competitiveness and personal gain without moral and legal limitation. The big fish eats up the small ones. So, the rich are becoming richer and the poor are getting much poorer.

Private ownership, individual freedom, freedom of exploitation, freedom of consumption, all, are the cornerstones of the capitalist doctrine. Now, the capitalists themselves have finally began to realize the negative effects of their doctrine on the economic life and the spiritual structure of the society.

The history of capitalism is the history of crime, injustice and oppression against peaceful people. The people of Africa were among those victimise.

The British and French traders used to burn African villages so that their residents were terrified into fleeing their hearts and homes.

Now, in the United States, the of the capitalist world, there is no denial that some sort of democracy and freedom exists. But, we shouldn't forget the other social and economic bi-products of the capitalist system. The realities of recession, inflation, unemployment, deficit and debt are pressing the U.S. administration to find some solutions.

Poverty, hunger and homelessness have caused high homicide rate. This has jeopardized people's security in America and some other Western countries.

To escape from these social and economic problems, American administration tries to transfer its crises to other countries. At the same time, it tries to make it pay. An example is "Operation Desert Shield." The United States government, already in trouble financially, demanded money from Japan, West Germany and Saudi Arabia to finance this operation. If it has come to the point that military deployment is the last solution for capitalism, then the only alternatives are fundamental change or total collapse (or both). "Islamic banking" : Islamic banking is a part of the Islamic economy and Islamic economy is a part of the Islamic system. So, to comprehend the Islamic banking system, it is important to study the whole Islamic economy.

We cannot separate the Islamic economy from the Islamic beliefs, Islamic conceptions, and Islamic sentiments. Also, it is not possible to separate the economy from the political system of society. The religious frame-work of economy in Islamic distinguishes of double ownership. There are private, public, and state types of ownership.

The rule of ownership are as follow:

- 1) The whole belong to God
- 2) Man is God's vicegerent
- 3) Ownership is not an end by itself. It is a means.
- 4) Man may benefit from God's bounties within rules.

Ownership may be gained through

1. Working: work is the essential origin of ownership
2. Transfer: e.g., purchase or gift
3. Inheritance

Aims of Islamic Economic : Islam intends that the gifts of God to the society be used to the maximum extent by that society, reasonably, without any waste or prodigality through responsible freedom, social justice, and just distribution.

To reach these aims, Islam emphasizes its control of the processes of gaining and consuming of wealth.

Islam fights usury, hoarding, amassing gold, and gathering an undue amount of wealth.

Islam considers as haram any wealth gathered through betrayals in trade, theft, bribery, selling short, overpricing, deceit in dealing , and selling of alcoholic beverages.

Islam is looking for prosperity and progress of the people.

The Prophet (P.B.U.H.) said: "I take refuge in Allah from blasphemy (kufur) and poverty."

To cut the roots of poverty, Islam has its own policy in taxation and distribution.

Although there are forceful instruments to fix the economy in Islam, the main pillars are spiritual aspiration and atmosphere.

Here is the power of the spirit which makes man sacrifice whatever he has. It is the same power that mobilizes the personal impulses for the sake of brotherhood and public interests.

From this point of view, man is the deputy of God on earth and his mission is not only earthly, but also heavenly. The Prophet of Islam (P.B.U.H.) came to give us happiness, tranquillity, brotherhood and love through making a new harmony between man and God, man and nature, and man and society. He said: "The believers are as one body; if one organ of it suffers, all the rest are sleepless."

For this reason I have chosen the following four countries with peculiar political, social, cultural and the economic features for my research to study Law relating to 'Musharaka' and Modaraba partnership financing as used by these four countries which are: "IRAN", "MALAYSIA", "PAKISTAN" AND "SUDAN". Now with this little back ground I am going to discuss briefly that how and when each of the above mentioned countries started their Islamic banking operations.

Islamic Banking In IRAN

Following the victory of Islamic Revolution in 1979, great efforts were made by religious and economic authorities of the country to include the religious laws in banking system regulations.

After extensive research and study undertaken by religious and economic experts, the "law four usury free banking" was finally approved in September, 1983. And was completely put into effect in banking system from the March 1984.

In the Islamic Republic of IRAN, the basic foundation and the general framework of the new banking operations are built on the Law of usury free banking, and this is some how different from the Islamic

banking system of the Islamic Republic of Pakistan. The operational frame work of which is only determined by directives and instructions of the contra bank.

This specific characteristic is the main feature of the Islamic banking system in Iran. The above mentioned Law which was ratified by Majlis (Parliament) on August 30, 1983, and was approved by the council of Guardians on September 1, 1983. Consists of five chapters, twenty seven articles and four notes, it determines the general frame work and the basic ground of banking operations in the Islamic Republic of Iran.

ISLAMIC BANKING IN MALAYSIA

The Muslims in Malaysia, like their counterparts elsewhere, had for along time had the desire to practise the rules of Syariah in the fields of banking and finance. This desire was especially rekindled when in the early 1970's there was a successful move to establish the Islamic Development Bank in Jeddah in 1974, and the Islamic Bank of Dubai being the first Islamic commercial bank in 1975 to be followed by a number of other similar institutions in many other Islamic countries.

Two institutions, namely the Pilgrims' Management and Fund Board and the Muslim Welfare Organisation of Malaysia, were particularly noteworthy in their initiate and efforts towards fulfilling this desire. They were joined in their endeavour by a number of other private organisation and individuals.

Their worthy efforts finally culminated in the appointment by the Honourable the Prime Minister of Malaysia of a National Steering

Committee on Islamic Bank on 30 July 1980. The Committee submitted its Report on 5 July 1981 which was accepted by the Government . Among others, the Committee recommended that:

- a) an Islamic bank, which operates according to the rules of Syariah, should be established;
- b) the bank should be incorporated as a limited company under the Companies Act 1965;
- c) in order to provide for licensing and supervision of the bank, an act styled the Islamic Banking Act 1983 should be legislated and some consequential amendments should be made to the existing related Acts;
- d) Bank Negara Malaysia (the Central Bank) should administer the Islamic Banking Act 1983;
- e) the Bank should set up a Religious Supervisory Council to supervise the compliance of its operations with Syariah principles.

Legal Framework

Islamic Banking Act 1983

Following the acceptance of the Report of the Steering Committee by the Government , the Parliament and the Senate had

legislated the Islamic Banking Act towards the end of 1982. The Act had been gazetted in 1983.

The Act seeks to provide for the licensing and regulating of Islamic banking business. It has been modelled on the country's existing Banking Act 1973 with modifications and amendments as are necessary to conform with Islamic banking practices. It basically ratifies the normal practices of prudent banking contained in the Banking Act 1973 and vests the Central Bank with similar powers of supervision and regulation over Islamic banks as in the case with other licensed banks.

A brief description of the Act is as follows:-

Part I contains the short title, commencement, application and interpretation;

Part II contains provisions relating to the licensing of Islamic banks;

Part III deals with the financial requirements and duties of Islamic banks;

Part IV deals with ownership, control and management of Islamic banks;

Part V pertains to the restriction on business;

Part VI related to powers of supervision and control over Islamic banks;

Part VII provides for miscellaneous matters such as indemnity, priority of sight and savings account liabilities, and penalties on directors and managers;

Part VIII contains provisions for consequential amendments that need to be made to other related Acts to enable Islamic banks to carry on their operations.

Incorporation of the Bank

The Bank has been incorporated as a limited company under the Companies Act 1965 on 1 March 1983 taking on the name of Bank Islam Malaysia Berhad with its registered office situated in Malaysia.

Its Memorandum of Association prefaces that "all businesses of the company will be transacted in accordance with Islamic principles, rules and practices". It lists among the company's first objectives as "to carry on the Islamic banking business in all its branches and departments and to transact and do all matters and things incidental thereto, or which may at any time hereafter at any place where the company shall carry on business be usual in connection with the Islamic banking business." The memorandum then proceeds to enumerate a number of possible objects for which the company is established, and seals the listing with the proviso "that nothing in this Memorandum contained also shall empower the company to carry on any business or do anything involving any element which is not approved by the Religion of Islam".

Islamic Banking in PAKISTAN

Pakistan was created in 1947 to enable Muslims to shape their destiny in accordance with Islamic ideals. However, certain institutions that the new born state inherited, were not in complete harmony with Islam .

During the first three decades of country's history, issues of creating and modifying socio-political institutions in accordance with the Islamic teachings were debated. This was done as a part of successive efforts at constitution making, and also as a corollary to the enforcement of different constitutions. In respect of 'Riba' , these

efforts led to the incorporation of a clause for its elimination in "Directive Principles of State Policy" of 1956 constitution, which was retained in subsequent constitutions promulgated in 1962 and 1973, subsequently, on different occasions the issue of riba free economy was also deliberated upon by the council of Islamic Ideology.

The Government, which came into power in 1977 in the wake of a mass movement, which campaigned for the introduction of Islamic System in all spheres of life pledged to work for the replacement of the interest based system by a system compatible with Islamic teachings. On September 29, 1977 the president of Pakistan entrusted council of Islamic Ideology with the task of preparing a black print for an Interest free economic system. In November 1977, the council appointed a Panel of Economists and bankers for compiling their recommendations on elimination of Interest.

The Panel presented its final report to the council of Islamic Ideology in February 1980 and with some modifications and substitution the council adopted this report on June 15, 1980. After these preparations and as a first step towards elimination of riba from the banking system. January 1, 1981 shall always be remembered as a day of great significance for the banking Industry in Pakistan, when all the 7,000 branches of the Nationalised Commercial Banks in Pakistan started accepting deposits on the basis of Profit and Loss Sharing (P.L.S.)

Islamic Banking In SUDAN

In Sudan a number of Islamic banks and their branches are now in operation and provide interest free loans and work on the basis of profit sharing.

The Faisal Islamic Bank of Sudan (FIBS) is one and was incorporated in 1974 as a public company under the companies Act (1925) with its headquarters in Khartoum. Due to its success, other Islamic banks were established and the Sudanese authorities have supported the Islamic banking movement. As a result, three other Islamic banks were opened in 1983, there were:

El-Tadamon Islamic Bank, the Sudanese Islamic Bank and the Islamic Co-operative Development Bank owned by co-operative union. In 1984, two other Islamic banks started operations , there were: Al-Baraka Bank (Sudan) and the Islamic Bank for Western Sudan.

The former regime in Sudan enacted laws in September 1983. As a result of this non-Islamic Commercial banks were asked to change their business activities to be consistent with the Islamic Shariah, and in September 1984 , the banking system was "Islamised".

A number of Islamic Investment companies were also established. e.g. Islamic Investment Company and Islamic Development Company and they were licensed under the Companies Act of (1925) to work in Sudan.

After brief summary of the Islamic banking operations in various Islamic countries , now this is a brief summary of contents of my thesis which is as follows:

In Chapter II, there is a brief survey of the History and development of Banking System, and the practices of modern commercial banks . Nowadays and an outline of operational strategies

of Bank of England, Unit Banking System of America and a little about world bank operations.

In Chapter III, I intend to summarize the Renaissance of Islamic banking and the Aim of Islamic economies because the present crisis of the the world economics is as the result of economic fluctuations. conventional commercial banking system are based on riba which is the bases of exploitation. While Islam is apposed to exploitation, and require fair dealing, Islam does not forbid to make profit . But it must be with in defined limits. And lastly I dicussed a possible model of Islamic Bank.

Chapter IV is about Musharaka (partnership) financing which is the first and the foremost bussiness instrument used by the earlier Muslims. In this chapter a brief summary of its development, legality, and conditions of the doctrine are discussed followed by a brief summary of the operational strategies of the doctrine in Iran, Malaysia , Pakistan and Sudan based on the legal framework of the respective country.

In the last chapter the subject of discussion is "Al Modaraba", its legality and conditions. An attempt has been made to discuss contemporary Islamic banking and its application in Iran, Malaysia , Pakistan and Sudan within their respective legal frame work. At the end there is a brief conclusion.