

An investigation into the establishment of an  
Islamic banking enterprise in the Tshwane  
and surrounding areas.

by

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## **ABSTRACT**

Muslims in South Africa live within the framework of a Western economy in which the notion of interest plays a pivotal role. This system does not seem to comply with the strict interpretation of Islamic law, since the Quran prohibits any dealings on the basis of interest and strongly condemns those who continue to deal in interest-based transactions, warning them of a “notice of war from Allah and His Apostle”.

Muslims are therefore faced with the dilemma of either participating in the current prevailing economic system and thereby violating the Quranic injunctions prohibiting interest or Riba, or completely withdrawing from participation in this system and conducting their business transactions in accordance with Islamic injunctions.

This study is an attempt to examine whether an Islamic banking enterprise within the greater Tshwane area could survive and even flourish in the long term if it were operating within the parameters of Islamic law, thus in the absence of the interest factor. The research methodology employed was that of qualitative research, and the study consists of both a literature and an empirical study.

It became evident from the literature review that a bank’s survival within the Western economic order depends on the confidence that its depositors have in it. In an Islamic economic system the ethical and legal components distinguish it from other systems. The most striking feature of the Islamic banking environment is the so-called profit and loss sharing system (PLS).

The literature study was complemented by an empirical study. Respondents were interviewed in three categories: Muslim businessmen, Islamic bankers and Islamic religious leaders.

An analysis of data from the respondents revealed that they were of the opinion that there was a need for an Islamic bank in order to avoid any interest-based dealings and

to operate strictly in accordance with Islamic law and principles. Based on the literature and field study a simple model of an Islamic banking enterprise was constructed which could function within the greater Tshwane area and within the South African economic context, but which would be based on Islamic Shariah principles. In constructing this model due cognisance was taken of the fact that it would prove to be a very difficult task to amend existing banking laws to provide for the easy entry and functioning of an Islamic bank.

Based on the literature and empirical study it was concluded that to provide for the easy entry and functioning of an Islamic banking enterprise, it should not be structured or named as a bank but rather as a finance company which would then be able to offer most of the services that are offered by traditional banks but without having to comply with the strict regulations as applicable to traditional banks.

The dissertation's final conclusion and recommendation was thus that an Islamic bank should operate not as a bank but as a finance company, thereby accomplishing its pivotal role to enable Muslims to use these indispensable services successfully while complying wholly with Islamic Shariah law.

## **KEY WORDS**

interest, Sharia law, Quran, Islamic economic system, profit and loss sharing system, banking enterprise

## OPSOMMING

Moslems in Suid-Afrika lewe binne die raamwerk van 'n Westerse ekonomie waarin die begrip rente 'n deurslaggewende rol speel. Hierdie stelsel blyk nie in lyn te wees met die streng vertolking van Islamitiese reg nie, aangesien die Koer'aan enige transaksie verbied wat op die betaling van rente gebaseer is en 'n sterk oordeel uitspreek oormense wat voortgaan met rentegebaseerde transaksies deur hulle te waarsku dat dit 'n "notice of war from Allah and His Apostle" inhou.

Moslems ervaar gevolglik die dilemma om óf deel te neem aan die huidige heersende ekonomiese stelsel, waardeur hulle die Koer'aan se opdragte verontagsaam wat rente oftewel Riba verbied, óf om hulle te onttrek van deelname aan die stelsel en hulle sake-transaksies te bedryf met inagneming van die Islamitiese wette.

Hierdie studie poog om vas te stel of 'n Islamitiese bankonderneming binne die groter Tshwane-gebied sou kon oorleef en selfs sou kon floreer as dit sou opereer binne die beperkings van Islamitiese reg, dus in die afwesigheid van rentegebaseerde transaksies. Die navorsingsmetodologie wat gebruik is was kwalitatiewe navorsing, en die studie berus op sowel 'n literatuurstudie as 'n empiriese studie.

Dit blyk uit die literatuurstudie dat 'n bank se oorlewing binne die Westerse ekonomiese bestel afhang van die mate waarin die beleggers vertrou het in die stelsel. 'n Islam-gebaseerde ekonomiese stelsel word van ander stelsels onderskei deur die sterk etiese en wetlike komponente daarvan. Die mees opvallende kenmerk van die Islamitiese bankomgewing is die sogenaamde wins-en-verliesdeelstelsel.

Die literatuurstudie is aangevul deur 'n empiriese studie. Daar is onderhoude gevoer met respondente in drie kategorieë: Moslem-sakelui, Islam-bankiers en Islam-godsdienstige leiers.

'n Ontleding van die gegewens wat van die respondente verkry is laat sien dat hulle meen dat daar 'n behoefte bestaan aan 'n Islam-gebaseerde bank wat enige rente-draende transaksies vermy en wat bedryf sal word in streng ooreenstemming met Islamitiese reg en beginsels. Op grond van die literatuur- en empiriese studie is 'n eenvoudige model van 'n Islamitiese bankonderneming gekonstrueer. So 'n onderneming sou dan kon funksioneer binne die groter Tshwane-gebied en binne die Suid-Afrikaanse ekonomiese konteks, maar dit sou dan gebaseer wees op Islamitiese Sharia-beginsels. In die konstruksie van die model is rekening gehou met die feit dat dit 'n baie moeilike taak sou wees om bestaande bankwetgewing verander te kry om sodoende voorsiening te maak vir die vlot toetrede en funksionering van 'n Islamitiese bank.

Op grond van die literatuur- en empiriese studie is daar tot die gevolgtrekking gekom dat ter wille van die vlot toetrede en funksionering van 'n Islamitiese bankonderneming die struktuur of naam van 'n bank nie daarvoor gebruik moet word nie, maar dat dit eerder as 'n finansieringsmaatskappy bedryf moet word wat dan soortgelyke dienste sou kon lewer as die tradisionele banke maar sonder dat so 'n maatskappy nodig het om te voldoen aan die streng regulasies wat van toepassing is op tradisionele banke.

Die studie se slotsom en aanbeveling is dus dat 'n Islamitiese bank nie as bank bedryf moet word nie, maar as 'n finansieringsmaatskappy. Hierdeur sal dit 'n sentrale rol kan speel om Moslems daartoe in staat te stel om hierdie onmisbare dienste suksesvol te gebruik, terwyl hulle ten volle voldoen aan Islamitiese Sharia-regsbeginsels.

## **SLEUTELWOORDE**

Koran, Sharia-beginsels, Islamitiese bankonderneming, wins-en-verliesdeelstelsel, bankmodel, Moslems, finansieringsmaatskappy

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## GLOSSARY

Al-Ijara	Financing the use of services of an asset through leasing
Al-Qarda-al-Hasan	Benevolent loans, that is, loans which are returned at the end after an agreed period of time and without any interest
Gharar	Uncertainty risk speculation, gambling or cheating not permissible in Islam
Holy Quran	Holy book of Muslim, primary source of Islamic law as revealed by the Prophet Muhammad (peace be upon Him)
Ijara-wa-Iqtina	Also known as lease purchase financing where equipment or fixed property is bought by the financier, rented to the user and which is eventually bought by the user
Ijma	Consensus among Muslims jurists on a particular point of view
Istisna	This entails paying at the present time for delivering, at some later, preagreed time, a commodity that has yet to come into existence
Jihalat	Literally “ignorance”; used to refer to a party that enters into a transaction in which there is a complete lack of knowledge regarding the outcome
Mudarabah	Trust financing where one party invests capital which the other party uses for trade or investment
Mudarib	Fund manager
Murabaha/Bai Muajjal	Cost plus trade financing; seller supplies goods to the buyer at a specific profit margin mutually agreed between them, in which the terms of payment could either be cash or in another form
Musharakah	Participatory financing where funds are provided as equity or working capital
Qiyas	Analogical reasoning used by Muslim scholars to solve any dispute in Islam

Raab-al-Maal	The financier or the one who provides the funds, e.g. depositors
Riba	Interest and/or usury
Salam	This entails paying at the present time for a commodity to be delivered at some later, preagreed time (useful in agricultural sector)
Sharia	Islamic law
Sunnah	Practice of the Prophet Muhammad (Peace be upon Him)
Takafol	Islamic insurance which is permissible when it is cooperative in nature
Torah	Holy book as revealed to Moses
Wakalah	Contract of agency where one person appoints someone else to perform a certain task on his/her behalf, usually against a fixed fee
Zaboor	Holy book as revealed to the Prophet David (Peace be upon Him)
Zakaat	The obligatory 2, 5% yearly tax on Muslims who possess in excess of a certain amount of wealth (Nisab) in money

## **LIST OF ABBREVIATIONS**

AED	Arab Emirate Dirham
ATM	Automated Teller Machine
BCBS	Basel Committee on Banking Supervision
BIMB	Bank Islam Malaysian Berhad
BIS	Bank for International Settlements
CDOs	Collateralised debt obligations
CRAR	Capital to Risk (weighted) Assets Ratio
DIB	Dubai Islamic Bank
DIS	Deposit Insurance Scheme
EGP	Egyptian pound
EPS	Earnings per share
FIBE	Faisal Islamic Bank of Egypt
FICA	Financial Intelligence Centre Act
FSA	Financial Services Authority
IBID	Islamic Bank International of Denmark
IBS	Islamic Banking System
IDB	Islamic Development Bank
IFI	Islamic Financial Institution
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
KYC	Know your client
M1	Currency and cheque deposits
M2	Money plus near money deposits
M3	Money, near money deposits and other liquid financial claims

MCCA	Muslim Community Cooperative of Australia
NPS	National Payment System
PBUH	Peace Be Upon Him
PAB	Phillipine Amanah Bank
PLS	Profit and Loss Sharing scheme of financing
RO	Representative Office of a foreign banking institution
SADIS	South African Deposit Insurance Scheme
SARB	South African Reserve Bank
SEC	Securities Exchange Commission
SMEs	small- and medium-sized enterprises
SMMEs	small-, medium- and micro-sized enterprises
UAE	United Arab Emirates

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# CHAPTER ONE: INTRODUCTION AND THE SCOPE OF THE STUDY

## 1.1 INTRODUCTION

At present over 1,4 billion people, or 20 per cent of the world's population, hold an Islamic world view (Abdullah & Chee, 2010:2) and it is a commonly held view among them that Islam is not only a religion but also a way of life (Khalil, 2004:46), be it political, economical or social. According to Iqbal and Mirakhor (2011:13) Muslim countries were under colonial rule throughout the nineteenth and for the greater part of the twentieth century and during this period lost much contact with their old traditions, values and actual heritage. Although there has been evidence of resistance towards the colonial values and a desire to return to their Islamic values such efforts were not widespread. In fact it was only after the end of the colonial period that Muslims expressed a desire to manage their affairs in accordance with their own values.

According to Presley and Sessions (1994) in Western economic philosophy man is regarded as inherently a selfish being who acts in his own interest. Even individual governments and groups of countries (like the European Union) sometimes function to the detriment of other countries. Whilst this is a reality of the modern world, it is not a common feature of Islamic economic theory, where the point of departure is strikingly different in that it describes how people, groups or governments ought to act in a perfect Islamic community and how the Quran expects them to behave.

Throughout the Muslim world efforts to discover and implement Islamic solutions to contemporary problems have intensified; the attitude of Islam to all innovations being that nothing should stand in the way of their adoption if they are useful to human society and so long as they do not conflict with the fundamental principles as enunciated in the Holy Quran and Sunnah<sup>1</sup> (Ahmad, 1984:2). Western

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<sup>1</sup> Teachings of the Prophet Muhammad (Peace be upon Him) about the Muslim way of life.

dominance created a huge gap between human actions and the Islamic intent in most Muslim countries; however, there is a continuous attempt to narrow this gap in all walks of life.

Western dominance, for example, created the widespread acceptance of the practice of taking and charging interest in spite of fundamental religious opposition to this practice, since the Quran prohibits dealing on the basis of interest. Those who persist in the practice of charging interest are given a “notice of war from Allah (God) and his apostle” (Quran, 2:279). From an economic perspective Muslims have therefore proclaimed that an economic system that is based on Islamic law is feasible even fourteen centuries after the emergence of their religion. To practice what they preach and to follow the Sharia (Islamic law), Muslims all over the world are attempting to put this system into effect, South African Muslims being no exception. The establishment of Islamic financial institutions and other business enterprises constitutes a major breakthrough in this movement.

This study will attempt to demonstrate whether a bank as a business enterprise could survive and even flourish in present-day South Africa, despite an absence of the interest factor on the money it will borrow from its depositors and will lend to its debtors. Obviously the revenue and cost structures of such a bank would necessarily differ considerably from those of its competitors and its marketing strategy would reflect such differences.

The Islamic principles that relate to the economic conduct of believers will be probed into in order to establish a framework within which an Islamic bank might legitimately interact with other participants in the banking market place. However, this market place is governed by South African legislation and the study must therefore also review such legislation with a view to isolating any aspect which might inhibit the interaction process, and to suggest means by which such obstacles might be overcome.

Elsewhere in the world there are technologically advanced nations that do subscribe publicly to Islamic law. Banks in these lands have been able to fulfill their pivotal economic roles without forfeiture of profitability. This would suggest that the Western presupposition regarding the necessity for the interest factor in banking might be invalid, even on purely commercial grounds. It will also be attempted by means of a literature study and field study to construct a simple model of an Islamic bank that could survive within the South African economic and legal context based on the profit and loss sharing basis.

## **1.2 PROBLEM STATEMENT**

South African Muslims are living today within a framework of the Western economy, an economic system on which the Muslims are dependent either directly or indirectly for their survival and advancement. However, the practices of such economic and financial system do not seem to be in accordance with the strict letter of Islamic law. As has already been mentioned, the Quran has prohibited dealing or trade on the basis of interest, and those who persist in practicing the charging interest are given of a “notice of war from God and his Apostle” (Quran, 2:279).

For many years this situation has placed South African Muslims in a very difficult position. They have been faced with the dilemma of either participating in the practices of the financial or banking system which exists in society, or withdrawing from it, thereby endangering their economic survival and certainly retarding their economic progress.

Muslims are faced with the critical issue that if they do participate in the present economic order they would be guilty of violating the Quranic injunction prohibiting interest, or Riba. This issue of interest has been in the forefront of controversy for South African Muslims for many years. The dominance of the interest-based

financial system in South Africa and the lack of recognition of some viable alternatives to interest-based transactions have forced many South African Muslims to carry on their financial business with the traditional banks. On the other hand others have rejected the interest-based practices that lead to the hoarding of money.

On the question of hoarding, Muslims are also given a stern warning in the Quran as not to hoard because those who continue hoarding “announce unto them a most grievous penalty on the day when heat will be produced out of that (wealth) in the fire of Hell, and with it will be branded on their foreheads, their flanks and their backs” (Quran, 9:34). Hence Muslims are in a predicament of having to choose between two evils, whether to hoard or practice interest, until a genuine alternative is offered whereby financial business can be conducted on an interest-free basis. The existing situation therefore seems to divide the South African Muslim community into three groups:

- those who actively participate in interest-based transactions,
- those who reluctantly deal with interest-based banks, and
- those who oppose any dealings involving interest.

The question that faces the Muslim community in South Africa therefore can be quite simply formulated as follows: what should the members of the Muslim community do in respect of the choice that lies before them: participating fully in the economic order of South Africa, or refrain from participation and living solely upon the very limited possibilities under the tenets of Islamic economic law in a foreign environment. The fact of the matter is that Muslims still need banking services as much as anyone else and for many purposes: to finance new business ventures, to buy a house, to buy a car, to facilitate capital investment, to undertake trading activities, and to offer a safe place for their savings.

Muslims in South Africa also have a responsibility of providing employment for all people and therefore are required to play their proper part in the industrial revolution now taking place in South Africa. This they can do only if they are allowed to operate within their own economic order. Such an economic order would have a twofold effect, for it would allow Muslims to conduct their business in line with Islamic principles, and the wealth generated would contribute substantially to all in the provision of employment, education, religious development and social upliftment. The principle which emerges from this is that Islam encourages investment in order for the community to benefit. However, it is not in favour of those who do not wish to invest and take risks but rather are content with hoarding money or depositing money in a bank in return for receiving an increase on these funds while not running any risk. Accordingly, under Islamic law principles people either invest with risk or suffer loss through devaluation by inflation by keeping money idle. Islam encourages the notion of higher risks investments, the underlying rationale being that high risk investments will provide a stimulus to the economy and encourage entrepreneurs to maximise their productivity.

### **1.3 PURPOSE OF THE STUDY**

The purpose of the study is to investigate whether an Islamic banking enterprise in compliance with Sharia principles can survive and even flourish in the greater Tshwane area of South Africa despite an absence of the interest factor.

### **1.4 OBJECTIVES OF THE STUDY**

#### **1.4.1 Primary objective**

The primary objective of the study is to investigate the feasibility of establishing an Islamic banking enterprise in Tshwane and its surrounding areas with special attention to its potential of long-term survival.

### **1.4.2 Secondary objectives**

The following secondary objectives are relevant in supporting the achievement of the primary objective:

- to present the envisaged Islamic bank as a solution to the problems and crisis in the banking industry;
- to examine the principles of modern banking and also the business aspects of South African banks;
- to identify the general framework of Islamic law, the nature of the Islamic system and Islamic attitude towards interest, and
- to establish to what extent the Al Baraka Bank in South Africa is complying with Islamic principles.

## **1.5 RESEARCH METHODOLOGY**

The study will consist of a literature study, as well as an empirical study and an analysis of personal interviews. According to Hart (1993:6), the most powerful social survey is one that combines the questionnaire method, which achieves representativeness, with insights generated by case study of selected individuals.

The three different approaches will be outlined in the following sections.

### **1.5.1 Literature study**

A literature study has been undertaken on the relevant subject of study so as to provide a better insight into the research problem as well as the necessary background to guide the empirical part of the study.

Information has been obtained from textbooks, journals, magazines, newspapers

and the internet. Relevant information has also been obtained from Islamic libraries in Tshwane, from the Department of Trade and Industry, and from Chambers of Commerce. Contact with embassies such as those of Saudi Arabia, Egypt, and the United Arab Emirates has been sought and they have been approached for relevant literature. Statistics and other relevant information have also been used during the study.

The abridged Harvard method of source referencing and acknowledgement has been used.

### **1.5.2 Empirical study**

The report on the literature study is followed by an exposition of the empirical study. An empirical investigation has been undertaken which provides a practical basis to ensure that a reasonably accurate version of current practice by Muslim entrepreneurs is given, which measures up to the purpose of the study. The survey method was used to obtain relevant data to be analysed. For this research a research instrument in the form of a questionnaire was developed based on the literature review and exploratory interviews.

A statistically representative sample of the population has been surveyed because it was not feasible to study the whole population. The target population comprises Muslim-owned small- and medium-sized enterprises (SMEs) in the greater Tshwane area. A random sample of ten percent of these businesses was targeted. The results of the questionnaires have been tabulated and analysed.

## **1.6 DEMARCATION AND LIMITATION OF THE STUDY**

For practical reasons such as the cost involved, the study is limited to SMEs that operate in the City of Tshwane Metropolitan Municipality and surrounding areas. For purposes of this study, this region consists of the areas listed in Table 1.1

below. A sufficient number of Muslim entrepreneurs are located in the Tshwane area and have been operating in the area for many years. Indian Muslims first arrived in Pretoria around 1881 making a living out of hawking fruit, vegetables, glassware, shoes, clothing and blankets. Many of them, such as Mahomed Hajee Joosab, Hajee Suliman Ebrahim and Mr Carrim, through such humble beginnings, prospered as early traders and eventually purchased motor cars improving their mobility and income. Later they opened retail stores around the Pretoria station and then in Church and Prinsloo Streets. Today they are leading business figures in the Pretoria area and have ventured into the manufacturing, wholesale, retail and industrial sectors of the economy. Mr Yusuf Abramjee, 702 Talk Radio station manager, also hails from Pretoria. His father is a well-known businessman in Pretoria. Dr.Suliman Carrim, chairperson of the school board of the Central Islamic School, is also a prominent Pretoria businessman (Pretoria News, 2003). Some of the leading Muslim-owned businesses in Pretoria are Metro, Kit Kat Wholesalers, Fashion World and Amka (Pty) Ltd. They provide employment for many people in and around Pretoria and hence participate fully in the economic activities of South Africa. The Muslims of Pretoria also have established their own private schools such as the Tshwane Muslim School, Al Ghazalli Muslim School, Al Asr Muslim School and the Pretoria Muslim Sunni Trust School. Muslims also operate the Louis Pasteur Hospital in Pretoria. Tshwane also boasts one of the best legal minds, the late Chief Justice Ismail Mahomed, formerly of the Constitutional Court (Tshwane Community Library and Information Services, 2004). Muslims in Pretoria have been an integral part of the economic growth and development of the greater Tshwane area and the fact that they also need banking services to finance new business ventures, to facilitate capital investments and to offer a safe place for their savings, led to the decision to carry out the study in the Tshwane area. The survey has only included a representative random sample of the total population as time and costs involved made it unfeasible to study the whole population.

**Table 1.1 Tshwane and surrounding areas**

a) Bronkhorstspuit	h) Mamelodi
b) Centurion	i) Pienaarsrivier
c) Cullinan	j) Rooihuiskraal
d) De Wildt	k) Rust de Winter
e) Ekangala	l) Soshanguve
f) Hammanskraal	m) Pretoria
g) Bapsfontein	

## 1.7 STRUCTURE AND ORGANISATION OF THE STUDY

The study comprises eight chapters, which can be summarised as follows:

<b>CHAPTER</b>	<b>SUBJECT</b>
<b>Chapter 1</b>	Introduction and scope of study
<b>Chapter 2</b>	Principles of banking
<b>Chapter 3</b>	Islamic law
<b>Chapter 4</b>	Islamic banking
<b>Chapter 5</b>	Empirical study
<b>Chapter 6</b>	Analysis and interpretation of study
<b>Chapter 7</b>	Construction of a model
<b>Chapter 8</b>	Conclusion and recommendations

Chapter 1 consists of the introduction and the scope of the study. It highlights the problem statement, research objectives and demarcation of the study. The research methodology is also spelt out in this chapter.

In Chapter 2 an overview of the principles of modern banking is provided as well as the legislative framework for credit control of South African banks and some

business aspects of South African banks. The chapter also looks into the effect of the financial crisis that has gripped the whole world recently. This recession, the worst since the Great Depression of the 1930's, has affected virtually every individual either directly or indirectly as a result of the market meltdown triggered off in the United States. Many leading commentators are now questioning the viability of the capitalist and fractional reserve system. In the light of the recent slides in the dollar exchange rate, the chapter will further probe the idea of holding on to a more stable currency such as gold and silver.

Chapter 3 will focus on the following: the general framework of Islamic law, the nature of the Islamic economic system, a definition of economics and Islamic economics in particular, and Islam's attitude towards interest.

In Chapter 4 the fundamental principles on which Islamic banking is based will be discussed, as well as some aspects regarding the establishment of Islamic banks, their sources of capital and bank earnings, and the Islamic banking movement as manifesting in different countries.

The purpose of Chapter 5 is to outline the design of the empirical research regarding an Islamic banking enterprise.

In Chapter 6 an analysis, interpretation and evaluation of the research findings will be undertaken.

In Chapter 7 an attempt is made to construct a model for an Islamic banking enterprise that could survive within the South African economic environment. From the literature and empirical study a simple model for an Islamic banking enterprise has been developed. An attempt will also be made to base the model on the adoption of gold and silver coins as a currency unit which would be represented by actual money containing a certain weight of gold and silver.

In Chapter 8 the findings of the entire study will be reviewed and summarised, followed by some recommendations on the establishment of an Islamic banking enterprise in respect of its long-term survival potential.

## **1.8 SUMMARY**

This chapter has provided an introduction and set out the scope of the study of establishing an Islamic banking enterprise in South Africa. It also expounds on the problem statement as it relates to the dilemma facing South African Muslims within the context of participating in banking business. Furthermore the chapter has also formulated the objectives of the research, the research methodology used, the demarcation and limitations of the study and finally the structure and organisation of the study. The next chapter will provide an overview of the principles of modern banking, the legislative framework for credit control, business aspects of South African banks, the impact of the financial crisis that has gripped the whole world recently and the idea of reverting to a more stable currency such as gold and silver.

## CHAPTER TWO: THE PRINCIPLES OF MODERN BANKING

### 2.1 INTRODUCTION

In this chapter the principles of modern banking will be reviewed so as to place the role of banks in perspective. Such a review should elucidate what is meant by the notion of a bank. During the course of this review it will become evident that a bank's survival mainly depends on confidence on the part of its depositors.

It will also become evident that a bank in acting as a business organisation would endeavour to maximise its profits by charging a higher interest rate on loans than it pays to its depositors. For similar reasons banks will seek to maximise the amount it lends and could thereby sometimes run the risk of being unable to repay deposits as a result of inadequate liquid funds when called upon to do so. This would result in loss of confidence and panic on the part of depositors, in all probability leading to a "run" on banks.

The banking system also has the unique capacity to create credit which in turn impacts directly on the money supply of a country. If uncontrolled, this capacity, coupled with the desire to maximise lending, can have significant repercussions in certain circumstances. Accordingly, authorities in most countries find it necessary to control or influence the degree to which banks are allowed to create credit. Control of credit is generally in the hands of a central bank and it will therefore be necessary to consider the ways in which such control can be effected. Control over the money supply has become crucial in the functioning of any modern economy and this requires clearly defined policies for the regulation of banks. History has shown that banks are sometimes unable repay deposits as a result of inadequate liquid funds when called upon to do so, as was the case with institutions such as the New Republic Bank, Fidelity Bank and Saambou in South Africa.

Since depositors often lose their savings in such defaults, there is a need to regulate the banking industry to ensure that adequate liquidity levels are maintained at all times; hence this chapter will also focus on the legislative framework within which South African banks have to operate. The chapter will further look into some business aspects of South African banks. Since banks run their operation typically like any other business, it would therefore be appropriate to review the sources from or ways in which a bank earns its revenue.

The chapter will also consider the recent financial turmoil that has occupied the headlines for the past few years, indicating that the United States is facing the worst financial crisis since the Great Depression of the 1930s; at present it is unclear whether this crisis is abating or still getting worse. In the light of the resulting financial crisis that has gripped the entire world, this chapter will also examine the idea of holding on to a more stable currency such as gold and silver. The chapter concludes with a brief look at the impact that the current financial crisis is having on Islamic banks.

## **2.2 ECONOMIC ROLE OF BANKS**

According to Hefferman (1996:15), a bank's main role is to take in deposits from some of its clients and make these funds available for lending to other clients. In this way the funds of the net savers' clientele of a bank are channeled to borrowers who are in need of money. By way of this process the bank becomes a debtor to those lending it money, and the bank's borrowers in turn become the debtors of the bank. According to Falkena, Kok and Van Der Merwe (1992:24) the differences between the rates of interest a bank pays to its depositors and the rate at which it lends to borrowers represent its margin of profit. This fundamental function of a bank therefore makes it a financial intermediary or an agent, reallocating funds from those in surplus to those in need.

Melicher (2005:51) stresses the point that banks speed up this process of borrowing and lending by making available to the lender a number of attractive

claims that induce him to forego his idle funds to those who are likely to spend it more readily than the lender would have done. According to Hadjimichalakis and Hadjimichalakis (1995:135) this service is performed by banks through the bank deposit which is a convenient form of money used to make payments almost anywhere without there being a need to carry large sums of currency. This convenience rendered by bank deposits makes the lender willing to hold liquid assets in this form rather than in currency. Banks pass on this liquidity to those individuals that they believe are in a good position to make productive use of it and at the same time will be able to repay it with interest.

Thus banks operate as middlemen of money in assessing the risks and profit prospects involved in making loans to potential borrowers. As specialists they perform this function better than individuals with cash to lend would normally be able to do themselves.

According to Cecchetti(2006: 440), banks are able to perform one economic function that no other financial institution is able to perform, namely its ability to create money. When the bank places depositors' funds in the loan sector it creates credit. This process of credit creation by banks affects the money supply and this has a direct impact on the spending of the community it serves.

## **2.3 BANK LIQUIDITY**

Hefferman (1996:165) refers to liquidity as the speed and certainty with which an asset can be converted into money without loss whenever the asset holder desires. On the other hand Hubbard (2005:25) refers to liquidity as the ease with which an asset could be exchanged for goods and services. Both writers seem to highlight the aspect of the ready acceptability of the asset by the public at large in exchange for goods and services; in other words, the asset should have a very close resemblance to money itself. Of all assets bank notes are the most liquid assets, followed by M1 and M2, where M1 refers to currency and cheque

deposits and M2 refers to money and near money deposits. However, Bascom (1997:152) defines liquidity as the ability to meet anticipated and contingent cash needs, and defines the risk as being measured by the probability that these needs may not be met. As alluded to earlier, Falkena, Kok and Van Der Merwe (1992:24) state that banks derive their profits from the difference between the average rate that they are required to pay to depositors and the average rate that they are able to charge borrowers. It thus follows that the primary motive for providing such service is to make a profit. As is the case with business enterprises generally, according to Zineldin (1990:31) banks aim at maximising this profit and consequently the desire to maximise profits would seem to give banks an incentive to increase their capacity to lend money to customers.

Kidwell *et al.* (2003:415) state, however, that banks cannot expand their loans and in turn their demand deposits indefinitely. Banks must conduct their operations in the knowledge that some proportion of depositors may seek to withdraw their funds unexpectedly and therefore banks need to maintain sufficient liquidity at all times. On the issue of liquidity bankers are aware of the possibility that all demand depositors could withdraw their money from the bank simultaneously; however, the probability of this happening is quite remote. On a daily basis there is normally a balance between people withdrawing their monies and others who make deposits to offset the withdrawals made.

Therefore it stands to reason that only a portion of deposits might actually be withdrawn by depositors on average. On the other hand Kidwell *et al.* (2003:416) stipulate that if a bank has insufficient funds to meet its depositors' demand then it must close its doors as this indicates they will be unable to meet their legal obligations to depositors, other creditors and borrowers. However, Cecchetti (2006:351) maintains that as long as depositors are confident that they can withdraw their deposits whenever they wish, they will on a balance of probability not do so. Confidence in the banking institution is therefore of prime importance. History has shown that banks are sometimes unable to repay deposits when

called upon to do so as a result of inadequate liquid funds. Such imprudence has led to bank runs, financial panic and bank failures. In South Africa there have been many banks that have gone out of business since the late 1980s, such as the New Republic Bank, Fidelity Bank, Saambou and Regal Bank. The phenomenon of spreading panic on the part of depositors could also be called contagion. Since depositors could lose their savings in such defaults, there is a need to regulate the banking industry to ensure that adequate liquidity levels are maintained. Since the private sector banking system in itself has no effective control mechanisms, control in the form of a regulatory statutory body becomes necessary. In most countries today central banks regulate the banking industry to ensure that adequate liquidity levels are maintained to prevent bank runs and to foster general public confidence in the banking industry.

According to Hubbard (2005:355) there are some strategies that central banks use in order to prevent bank runs. They are the following:

- **Deposit insurance system**

The implementation of a deposit insurance system such as in the United States (by the so-called Federal Deposit Insurance Corporation) that insures each depositor up to a certain amount, protects depositors in the event of a bank failure. This removes the need to withdraw one's deposits because others are withdrawing theirs.

- **Lender of last resort**

The central bank acts as a lender of last resort. To prevent a bank run the central bank guarantees that it will make short-term high-interest loans to commercial banks to ensure that if they remain economically liable, they will always have sufficient liquidity to honour withdrawals of their deposits.

- **Reserve ratio**

Central banks generally require commercial banks to hold liquid assets in certain prescribed ratios to deposits so that they do not channel excessive amounts of their deposits into illiquid overdrafts. A bank that is temporarily short of cash may then sell some liquid assets on the money market, thus obtaining cash to repay deposits that depositors wish to withdraw.

According to Goedhuys (1982:5) banks not only maximise profit by extending credit to their clients, but this also has the effect of increasing the aggregate money supply. The aggregate money supply represents the sum total of all those items that in the entire spectrum of financial assets are considered to be either a medium of exchange or a reasonably close substitute for it. Concepts commonly used in monetary analysis are M1 for money, being currency and cheque deposits; M2 for money plus near money deposits, and M3 for near money, money deposits and other liquid financial claims. The aggregate money supply is therefore represented by M3, which serves as a measure of the spending potential of the private non-banking sector.

According to Hubbard (2002:434) the aggregate money supply is an important factor in maintaining a healthy economy, but the aggregate supply of money can also exert inflationary pressure as it increases the effective demand for goods and services. To keep this inflationary pressure as low as possible the credit-creating capacity of banks must be controlled.

According to Vaish (1995:383) the controlling and stabilising function of the credit creation capacity of banks is in the hands of the central bank. At this juncture it would therefore be pertinent to examine the way in which banks can create credit.

## 2.4 CREDIT-CREATING CAPACITY OF BANKS

Goosen *et al.* (1999:36) maintain that banks can create credit via the fractional cash reserve system whereby bankers keep as liquid reserves only a fraction of the funds their clients deposit. The rest is lent out to people requiring funds at the rates that may prevail. The people to whom they lend the money deposit these funds into their accounts. The authors illustrate this credit-creating capacity by way of an example. They assume that there exists only one bank in a closed economy and all members of this economy maintain bank accounts at this bank and all funds that are received are deposited into their bank accounts. Suppose a client deposits R200 at Bank A and the bank is required to maintain a fractional cash reserve of 15% (the fractional cash reserve is the money which banks have to keep in order to meet cash withdrawals and adverse clearing balances). Of the deposit of R200, R30 will thus be kept for withdrawal purposes, leaving R170 to be lent out. This R170 is lent to A, who uses it to pay off his debt to B, who in turn deposits the amount into her account with the bank. The bank will again keep 15% (R25,50) of this deposit while lending out the balance of R145,50 to C who will use it to pay off his creditor D who in turn will deposit the payment received at the bank. The bank will again keep 15% (R21,67) of this deposit while lending out the balance of R122,83 to E.

This process of credit creation will continue until there are insufficient funds to lend out. The entire process commenced with R200 but more than R200 has been created. In order to determine how much money has been created one can use the formula for the credit multiplier supplied by Goosen *et al.* (1999:37):

$$D = \frac{1}{rd} \times R$$

where

**D** – is the amount of credit created

**R** – is the size of the deposit made

**rd** – is the reciprocal of the minimum kept by the bank (the cash reserve to

be held is 15%)

Thus in the case of the R200 deposited, the amount of money created is as follows:

$$\begin{aligned} D &= \frac{1}{r_d} \times R \\ &= R \frac{1}{0.15} \times R200 \\ &= R6,667 \times R200 \\ &= R1\,333,33 \end{aligned}$$

Thus a total of R1 333,33 has been created by the initial deposit of R200 assuming that a fractional cash reserve of 15% is being held. Central banks have a number of tools at their disposal with which they can regulate bank credit and the supply of money. These will be discussed in the following section.

## 2.5 CREDIT CONTROL

According to Bank (2007:1) the tools used by central banks for regulating the activities of commercial banks may be divided into:

- the so-called classical, or indirect techniques
- the various direct controls

The classical techniques make use of open market purchases or sales by the central bank of certain types of assets that are somewhat associated with fluctuations in interest rates. Direct or quantitative credit controls are employed so as to have an impact on the cash and liquidity base of commercial banks by means of freezing or unfreezing their liquid resources. At other times ceilings are imposed on bank loans. Each one of these techniques will be briefly reviewed.

## 2.5.1 Classical / Indirect controls

### *Open market operations*

This quite simply refers to the way in which open market operations influence cash reserves and through them the general liquidity of the commercial banks. When the central bank buys securities in the open market, the cash it offers in exchange adds to the reserves of the banks. On the other hand, when the central bank sells securities in the open market it decreases the cash reserves of banks directly or indirectly which in turn leads to a reduction in the money supply.

Hadjimichalakis and Hadjimichalakis (1995:9) define open market operation as an instrument of monetary policy pursued by the central bank to influence a nation's money supply, interest levels and ultimately its inflation and growth.

### *Discount rate policy*

The central bank's discount rate (also known as the bank rate) is the rate at which the central bank is prepared to lend to the banking system when the latter is short of liquid funds. An increase in the bank rate will curtail credit because banks can then rediscount their bills only at a higher rate. Such increases will immediately cause the wholesale rates in the money market to rise, since financial intermediaries will pay a higher rate on funds borrowed. Consequently there will be an increase in the retail rates charged by banks and other financial institutions to the public. The increased retail cost of credit will inhibit the public from further borrowing of funds. A decrease in the bank rate will have the opposite effect, as it will cause an increase in the demand for credit.

Authors such as Kidwell *et al.* (2003:49) and Hubbard (2002:521) are of the opinion that the upward or downward movement of the discount rate could be associated with having a certain "announcement effect". The change in fact is a

signal as to whether the central bank intends to adopt an expansionary or contractionary policy.

### **2.5.2 Direct controls**

Direct controls can be implemented by the central bank in four main ways. Briefly these are the following:

- The central bank of any country has the power to raise or lower the minimum cash reserve ratio to deposit requirement that banks must maintain, hence it follows that they have the power to lower or raise the maximum amount of deposits that banks may carry on the basis of any amount of reserves.
- Part of the cash resources of the commercial banks may be immobilised at the discretion of the central bank.
- Ceilings may be imposed on the amount of liquidity help that could be made available to commercial banks by the central bank when commercial banks in distress need liquidity. This is sometimes referred to as discount quotas. These ceilings could either be increased or decreased.
- Ceilings may be prescribed for commercial bank lending itself.

Vaish (1995:402) also cites moral suasion and publicity as other methods of credit control used in many countries. He distinguishes between direct action and moral suasion. Direct action can consist of coercive measures used by a central bank against defaulting banks whilst moral suasion is regarded as an attempt by a central bank to persuade financial institutions that it is both in their own interest and that of the country to pursue certain types of lending policies. It does this by virtue of the prestige it commands over other banks in the banking sector. With regard to publicity as a credit control strategy Vaish submits that central banks

frequently publish economic facts relating to both the states of affairs of the money market and the general state of the economy of the country. In using this strategy the central bank appeals to the community spirit to make a sincere attempt to remedy any adverse general business and credit conditions that might be prevalent.

## **2.6 LEGISLATIVE FRAMEWORK GOVERNING THE FUNCTIONING OF SOUTH AFRICAN BANKS**

Control over money supply has become crucial in the functioning of any modern economy and this requires a clearly defined policy for the regulation of banks. Ideally, the money stock will not disturb general price levels, but will allow for enough flexibility in the economy to support rising levels of production and employment.

In South Africa, the South African Reserve Bank (SARB) acts as the central bank. It is responsible for a number of authoritative functions and tasks which lie outside the confines of other banks and financial institutions. The basic responsibility of the South African Reserve Bank is the determination and implementation of monetary policy. It would therefore be appropriate to review how banking legislation protects depositors and more specifically how the South African Reserve Bank exercises credit control within the South African legislative framework.

### **2.6.1 South African legislation protecting depositors**

#### *Legal definition of a bank*

Section 1 of the Banks Act 94 of 1990 as amended (hereinafter referred to as “the Act”) essentially defines a bank as a public company or a person whose main business entails the accepting of deposits from the general public in a manner which the Registrar of Banks after consultation with the Governor of the

Reserve Bank has declared in the Government Gazette to be a manner of obtaining money for the purpose of carrying on the business of a banking institution. A bank uses any money so obtained mainly to grant loans or credit other than customary credit in respect of sale of goods or provision of services to the general public, or to conduct leasing or factoring business.

The above definition of a bank indicates that any person accepting money from the general public in whatever form and lending such funds to the public falls within the spheres of the business of banking.

In terms of section 11(1) of the Act it is required that the institution registers with the Registrar of Banks, whilst section 11(2) provides that any organisation conducting the business of a bank without registration would be guilty of an offence.

### *Registrar of Banks*

Section 3 of the Banks Act provides for the appointment of an officer to be styled the Registrar of Banks whose office is in Pretoria and is called the Office for Banks; it deals with the registration of banking institutions.

Section 6(2) of the Act further provides that besides the powers and duties conferred or imposed upon the Registrar in terms of the Act, his powers and duties correspond to powers and duties imposed by the Inspection of Financial Institutions Act 88 of 1998.

Section 12(1) of the Act further provides that any person who intends to carry on the business of a banking institution may apply to the Registrar for permission to establish a bank. Section 13(2) provides that the Registrar may grant such permission to the applicant if the latter can convince the Registrar that the proposed bank will be able to establish itself successfully as a bank and further

that it will conduct the business of banking as a public company in terms of the Act. Section 7 of the Act requires banks to provide the Registrar with any information as may be reasonably required to ascertain whether or not the bank is complying with all rules and conducting its business in a proper manner.

### *Liquid assets*

In terms of Section 1 of the Act, the notion liquid asset refers to Reserve Bank notes, subsidiary coins, gold coins and bullion, excluding the minimum reserve balance that a bank is required to maintain in terms of Section 10 of the South African Reserve Bank Act 92 of 1989.

The holding of sufficient liquid assets on the part of a bank is a safety measure for banks in the event of abnormal withdrawal of cash by depositors, and at the same time serves to protect depositors (Hubbard 2005:35).

Section 72(1) of the Act stipulates that a bank shall maintain liquid assets in the Republic of South Africa amounting to not less than the aggregate of 20% of such different categories of its liabilities specified by regulation.

### *Reserve requirements*

Section 10A of the South African Reserve Bank Act 92 of 1989 ensures that banks always have adequate liquidity. This also serves as a second line of defence and hence banks are required to maintain a certain amount of liquid assets as a minimum reserve balance with the South African Reserve Bank which does not earn interest. It is normally about 2,5 percent of the total liabilities of banks.

### *Share capital and unimpaired reserve funds.*

Section 70 of the Act further requires banks to maintain a minimum amount of share capital and reserve funds so as to ensure that they are of an adequate size and solidity.

### *Lender of last resort*

As lender of last resort the South African Reserve Bank guarantees ultimate liquidity of the financial system by being prepared to discount eligible bills from the discount house and grant short-term loans to them and the banks (Goosen *et al.*, 1999:149). However, Hubbard (2005:314) is of the view that the lender of last resort serves as an ultimate source of credit to which banks could turn during a panic and hence safeguard the interest of its depositors.

### *Bank supervision*

According to the 2005 Annual Report of the South African Reserve Bank Supervision Department, the following bear relevance to banking institutions:

- **Supervision of representative offices.** The Bank Supervision Department undertakes both onsite and offsite oversight to establish whether a representative office (RO) of a foreign banking institution adheres to applicable legislation. The onsite supervisory function entails annual visits to all registered ROs that are operating in South Africa, whereas the offsite supervisory function includes analysis of the quarterly returns submitted by ROs and the evaluation of the annual internal control reports submitted by ROs' chief representative officers.
- **Monitoring of banks' compliance with anti-money-laundering legislation.** The Bank Supervision Department continues to interact with

other supervisors both locally and abroad. According to the Report of the Basel Committee on Banking Supervision (2006) this committee consists of banking supervisory authorities and was established by the central bank governors of the Group of Ten countries in 1975. At present the committee members consist of senior representatives of bank supervisory authorities and central banks from more than 20 countries such as Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Basel Committee on Banking Supervision (BCBS) usually meets at the Bank for International Settlements in Basel where its permanent secretariat is located. The activities of this committee will be discussed in more detail in Section 2.6.2 below.

- **Combating of illegal deposit taking.** The Bank Supervision Department is responsible for the administration of the Banks Act 94 of 1990, in terms of which the registrar is responsible for, amongst other things, the controlling of deposit taking of persons not registered as banks or mutual banks.

### *Deposit insurance*

In the event of bank failures it is important that depositors' funds be safeguarded; hence the idea of implementing a deposit insurance scheme. South Africa does not have an explicit deposit insurance scheme (DIS) at present. During 2000, at the request of the then minister of finance, the Bank Supervision Department was required to participate in a joint project with the national treasury to investigate the requirements necessary to implement a South African deposit insurance scheme (SADIS). A work group was established to research the issues and to make proposals on the establishment of SADIS. Proposals on SADIS are

therefore being developed to serve the purposes and interests of South Africa.

*Alignment of the South African accounting statement with international financial reporting standards*

For the financial years commencing on or after January 2005, listed banks will have to prepare their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) which of course also include International Accounting Standards (South African Reserve Bank 2005).

*Appointment of auditors*

Section 61 of the Act empowers the Registrar of Banks to appoint an auditor should a bank for any reason fail to appoint auditors itself. If the auditor suspects any irregularities in the conduct of the affairs of the bank, then he or she is obliged to furnish the Registrar with copies of any reports and particulars thereof.

Section 63 of the Act further obliges the auditor to inform the registrar in writing of any matter relating to the affairs of a bank which in the opinion of such auditor may endanger the bank's ability to continue as a going concern; may impair the protection of the funds of bank's depositors; may be contrary to the principles of sound management or amount to inadequate maintenance of internal controls.

*Other legislation likely to affect the banking industry*

The National Credit Act 34 of 2005 which came into operation in June 2007 will have a profound effect on the manner in which credit will be extended, administered and reported in South Africa. The legislation created a new regulatory environment in which all credit providers, including banks, will have to face far-reaching changes in the way they do business. The principal objective of the Act is set out in the preamble to the Act, which includes inter alia the

following aims:

- the promotion of a fair and non-discriminating market place for access to credit
- the prohibition of unfair practices
- the promotion of responsible credit granting and the prohibition of reckless credit granting
- the provision of the general regulation of consumerised credit and improved standards of consumer information
- the promotion of black economic empowerment.
- the provision of debt reorganisation in cases of over indebtedness
- the establishment of national norms and standards with regards to consumer credit
- the promotion of a consistent enforcement framework relating to consumer credit and the establishment of the National Regulator and National Consumer Tribunal

In general it appears that the main purpose of the Act is to exercise some degree of control over the granting of credit by credit grantors in South Africa and to prevent any form of abuse of their power in the advancing of credit to the consumer segment of society. In this way the Act serves to work towards the interest of the consumer by protecting them against any possible unfair practices that could be employed by credit grantors.

## **2.6.2 International legislation protecting depositors: the Basel accords**

### **2.6.2.1** *The Basel Capital Accord of 1988: Basel I*

In the 1980s the BCBS, under the auspices of the Bank for International Settlements (BIS), developed a framework to determine capital adequacy standards for banks with the objective of promoting soundness and stability in the international banking system. This initiative resulted in the Basel Capital Accord

of 1988 (commonly referred to as **Basel I**) which laid the framework for a “regulatory capital” and defined the guidelines to measure risk exposures of different asset classes. In the main the accord maintains that those banks that are holding riskier assets should be required to have more capital on hand than those maintaining safer portfolios. Another aim of Basel I was to indicate a minimum recommended level of regulatory capital with a Capital Adequate Ratio (CAR) of eight per cent (Iqbal & Mirakhor, 2011:305).

### **2.6.2.2** *The Basel Capital Accord of 2006: Basel II*

In June 2006 the BCBS issued the *International Convergence of Capital Measurement and Capital Standards: A revised Framework*, known as the **Basel II** Accord. According to the Report of the BCBS (2006) the fundamental objective was to revise the 1998 Basel I accord because of the following considerations:

- To develop a framework that would further strengthen the soundness and stability of the international banking system whilst maintaining sufficient consistency so that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.
- The committee also believed that the revised framework would promote the adoption of a stronger risk management practice by the banking industry and viewed this as one of its major benefits.
- The committee also noted that in their comments on the proposals, banks and other interested parties did welcome the concept and rationale of the three-pillars approach (minimum capital requirements, supervisory review, and market discipline) on which the revised framework is based. More generally they have expressed support for improving capital regulation to take into account changes in banking and risk management practices whilst at the

same time preserving the benefits of a framework that can be applied as uniformly as possible at the national level.

- In developing a revised framework ,the committee had sought to arrive at a significantly more risk-sensitive capital requirement that conceptually appeared to be more sound and at the same time paid due regard to particular features of the present supervisory and accounting systems in individual member countries. It believes that this objective has been achieved. The committee also retained key elements of the 1988 capital adequacy framework, including the general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets; the basic structure of the 1996 Market Risk Amendment regarding the treatment of market risk, and the definition of eligible capital.
- An important innovation of the revised framework is the greater use of assessments of risk provided by banks' internal systems as inputs to capital calculations. In taking this step the BCBS is also putting forward a detailed set of minimum requirements designed to ensure the integrity of these internal risk assessments.
- The revised framework provides a range of options for determining the capital requirements for credit and operational risk in order to allow banks and supervisors to select approaches that are most appropriate for their operations and their financial market infrastructure.
- The BCBS has also given recognition to home country supervisors as playing an important role in enhancing cooperation between home and host country supervisors that will be required for effective implementation.
- The revised framework is also designed to establish minimum levels of capital for internationally active banks.

- The revised framework is more risk sensitive than the 1988 accord, but countries where risks in the local banking market are relatively high need to consider if banks should be required to hold additional capital over and above the prescribed Basel minimum.
- The BCBS also wished to highlight the need for banks and supervisors to give appropriate attention to the second pillar (supervisory review) and third pillar (market discipline) of the revised framework. It is critical that the minimum capital requirements of the first pillar be accompanied by a robust implementation of the second, including efforts by banks to assess their capital adequacy and by supervisors to review such assessments.

The message of Basel II is that a robust financial system infrastructure and adequate prudential surveillance at macrolevel are the prerequisites for effective supervision and risk management (Iqbal & Mirakhor, 2011:311).

### **2.6.2.3** *The Basel Capital Accord of 2011: Basel III*

The BCBS, in its document *Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems* published in their revised June 2011 version highlights the rationale underlying some reforms known as the Basel III Global Framework.

The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress. The document also takes into account those reforms which could prevent a future financial crisis. The committee also looks at ways in which it could improve risk management and governance as well as strengthen a bank's transparency and disclosures.

According to the abovementioned Basel III report the committee has attempted to raise the resilience of the banking sector by strengthening the regulatory capital framework, building on the three pillars of the Basel II framework. The reforms raise both the quality and quantity of the regulatory capital base and enhance the risk coverage of the capital framework. They are underpinned by a leverage ratio that serves as a backstop to the risk-based capital measures so as to constrain excess leverage in the banking system and further to provide an extra layer of protection against model risk and measurement error. The committee is also introducing a number of macroprudential elements into the capital framework so as to help contain systemic risks that may possibly arise from procyclicality and from the interconnectedness of financial institutions. Briefly these reforms revolve around the following:

- ***Raising the quality, consistency and transparency of the capital base.*** It is of critical importance that a bank's risk exposures be backed by a high quality capital base. The current financial crisis has demonstrated that credit losses and writedowns came out of retained earnings which form part of banks' tangible common equity base. It also revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital between institutions. To this end the main form of the so called Tier 1 capital must be common shares and retained earnings. Tier 2 capital would be harmonised and Tier 3 capital instruments, which were only available to cover market risks, were eliminated.
- ***Enhancing risk coverage.*** A major lesson learnt during the financial crisis is the need to strengthen the risk coverage of the capital framework. Failure to capture major on- and off-balance sheet risks as well as derivative-related exposures was a key destabilising factor during the crisis. In July 2009 the committee, in response to these shortcomings, drew up a number of critical reforms to the Basel III framework. These reforms will certainly raise capital

requirements for the trading stock and complex securitisation exposures, a major source of losses for many internationally active banks. The document also introduces measures to strengthen the capital requirements for counterparty credit exposures arising from banks derivatives repo and securities financing activities. These reforms will raise the capital buffers backing these exposures.

- ***Supplementing the risk-based capital requirement with leverage ratio.***

The committee also intends introducing a leverage ratio requirement so as to achieve the following objectives:

- Constrain leverage in the banking sector, thus helping to mitigate the risk of the deleveraging processes which can damage the financial system and economy.
  - Introduce additional safeguards against model risk and measurement error.
- ***Reducing procyclicality and promoting countercyclical buffers.*** The BCBS intends to introduce a number of measures so as to make banks more resilient to procyclical dynamics. These measures would ensure that the banking sector would serve as a shock absorber, instead of a transmitter of risk to the financial and broader economy.
- ***Addressing system risk and interconnectedness.*** The BCBS and the Financial Stability Board are developing a well-integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt.
- ***Introducing a global liquidity standard.*** Strong capital requirements are a necessary condition for banking sector stability but in themselves they are not sufficient. A strong liquidity base reinforced through robust supervisory

standards is of equal importance. To date, however, there have been no internationally harmonised global liquidity standards. Established global liquidity standards would promote an level international playing field to help prevent a competitive race to the bottom.

## **2.7 LEGISLATION GOVERNING ACTIVITIES OF THE SOUTH AFRICAN RESERVE BANK**

According to a 2006 Report compiled by the Research Department of the South African Reserve Bank Information Division, the South African Reserve Bank (SARB) and the National Treasury (Department of Finance) together constitute the monetary authority of South Africa. The South African Reserve Bank acts as South Africa's central bank, is co-responsible for formulating South Africa's monetary policy and is largely responsible for its implementation. Its primary goal, as defined in the constitution, is to protect the value of the currency. The SARB's management, powers and function are governed by the South African Reserve Bank Act 90 of 1989. The Research Department groups the current functions of the banks into the following five areas of responsibility, each one being discussed here briefly:

### **A) Formulation and implementation of monetary policy (aimed at achieving the inflation target)**

- ***Refinancing system and interest rates***

In 1998 the SARB implemented a system of repurchase transactions (repos) as the main instrument for managing liquidity in South Africa's money market. The repo rate is the price at which the central bank lends cash to the banking system and it has become the most important indicator of short-term interest rates.

- ***Open-market operations***

Open-market operations are conducted for two reasons: they must neutralise or smooth the influence of exogenous factors on the liquidity position in the money market, and maintain a liquidity requirement in the market at the level of the cash reserve requirement so as to influence interest rates.

The Reserve Bank uses the above tools also as a monetary instrument to achieve its monetary objectives together with changing the cash reserve requirement of banking institutions and also changing the marginal lending facility.

## **B) Services to government**

- ***Gold and foreign exchange reserves as well as exchange rate policy***

The Reserve Bank is the custodian of the major part of the country's gold and foreign exchange reserves.

- ***Banker and advisor to the government***

The main services provided in this capacity are administering the auctions of government bonds, Treasury bills and also managing the flow of funds between the Exchequer Account and the tax and loan accounts.

- ***Administering of exchange control***

The Reserve Bank also sees to it that there is compliance with exchange control regulations.

### C) **Provision of economic and statistical services**

The bank collects, processes, interprets and publishes information such as economic statistics.

### D) **Financial stability**

- ***Bank supervision***

The aim here is to achieve a sound, effective banking system in the interest of depositors of banks and the economy as a whole. This was dealt with at length in section 2.6.1.

- ***The National Payment System***

The Reserve Bank is responsible for overseeing safety and soundness of the National Payment System (NPS). The main aim here is to reduce interbank settlement risk with the objective of reducing the potential of a risk crisis emanating from settlement default by one or more of the settlement banks.

- ***Banker to other banks***

The Reserve Bank acts as a custodian of the cash reserves that banks are legally required to hold or prefer to hold voluntarily with the SARB.

- ***Bank notes and coins***

The Reserve Bank controls the South African Mint and issues bank notes printed by the South African Bank Note Company; a wholly owned subsidiary of the SARB.

- ***Lender of last resort***

In terms of its lender of last resort activities the SARB may in certain

circumstances provide liquidity to banks experiencing liquidity problems.

- ***Monitoring financial stability***

The bank monitors the macroprudential aspects of the domestic financial system. The objective of financial stability is to prevent costly disruptions in the financial system of the country.

**E) Provisions of internal corporate support services and systems**

In order to ensure its own smooth operation and internal administration the SARB has an extensive and integrated system supported by information technology and human resources services.

## **2.8 BUSINESS ASPECTS OF SOUTH AFRICAN BANKS**

### **2.8.1 Sources of bank revenue**

According to Croxford (2006:17) retail banking is based on a simple, straightforward model. Whilst some individuals and enterprises have a surplus of funds, others have a deficit. Banks borrow from those in surplus and lend it to those in deficit. The bank makes an interest rate spread between the two. Banks are also noted for providing ancillary services for which they charge fees as and when customers use them. The bank thus makes revenue from the net interest income. The remaining portion of the income is derived from commission, fees and other charges arising from the selling of financial and other services. These include payment for services such as insurance, money transmission, advisory services, card and factoring services and investment, trust, will and card services. All the service fees added together represent the non-interest income of the bank.

Banks run their operations like a business, for whilst a business product could be a piece of equipment, machinery, clothing or food, the banks' product is cash or money. They sell this money in the form of loans and other types of financial products. They make their profit on the interest and fees they charge on loans granted and they pay depositors for investing that money. The success of a commercial bank therefore depends on its ability to attract and retain its clients and on how much of the clients' business it attracts (Melicher 2005:71).

Goosen *et al.* (1999:235), Croxford (2006:44) and Hubbard (2005:295) briefly discuss each category of banking services which are as follows:

*Banking services related to borrowing and lending*

- **Overdraft facilities**

According to the abovementioned authors this is the single most important banking function as well as the principal source of revenue to the bank. By way of an overdraft facility, individuals and business concerns who require cash can make arrangements with the bank with whom they have current banking accounts to pay out more money than the amount which the customer has to his credit. Clients pay interest on the amount that they receive.

- **Credit cards**

Bank credit cards provide the holder with a preauthorised line of credit up to some specified amount. These cards can be used to acquire cash directly from a bank, or pay for merchandise obtained from merchants. Banks normally charge a fee for this service.

- **Term loans**

A term loan is a credit facility repaid over a specified fixed period of time. The interest rate applicable to the account is linked to the prime rate of interest and also reflects the risk associated with the loan.

- **Installment credit**

This type of finance facility enables the borrower to obtain an asset such as a car while repaying the amount borrowed with interest over an agreed period of time.

- **Garage and petro card facilities**

A garage card allows the cardholder to pay for petrol, oil, spares and repairs at garages and service stations in South Africa, reducing the need to carry cash when travelling.

- **Home loans**

Banks grant long-term finance (usually up to 30 years) to facilitate the purchase of vacant land and existing and new residential and business properties, as well as for additions or extensions to such properties.

- **Leasing**

In a lease agreement, the lessee is allowed to use an asset by paying rental in advance to the bank. The bank retains ownership of the goods for the duration of the lease and none of the parties have the intention of passing ownership onto the lessee at any stage.

- **Specialist loans**

Banks also charge commission in different circumstances that require different facilities. Such loans fall for instance in the category of bankers' acceptance bills discount, project finance, factoring, guarantees, or letters of credit.

*Banking services not related to borrowing and lending*

- **Assurance**

Assurance refers to a type of policy which covers an event that is assured to take place, e.g. upon the death of the insured the entire amount of life assurance would be paid out. Banks offering assurance policies operate as agents for assurance companies and do not normally charge for their services because they receive commission from the assurance company concerned.

- **Insurance**

Insurance is aimed at covering certain goods or possessions against potential damage or loss (e.g. physical damage to property, household contents covered against risks such as burglary, fire or storms, motor insurance). As with assurance, banks that offer this service to their clients act as agents for insurance companies and receive commission from the insurance company concerned.

- **Travellers cheques**

Banks issue travellers cheques to persons travelling within South Africa or

going abroad. The money is paid into one bank and paid out on demand to another bank elsewhere when needed. However, this instrument is at present being replaced by cash passports and other forms of access to money while travelling.

- **Foreign currency**

Banks that are licensed to do so maintain stocks or an inventory of foreign currencies. They act as if they were agents for foreign currencies which clients use for travel and tourism, business and personal purposes such as migration, family aid or donations. The bank earns commission on these transactions and in addition the difference in the price paid and received for currency will usually provide a dealing profit.

- **Bank reports**

This service is furnished to a prospective seller who may want information regarding the creditworthiness of a prospective buyer. The seller's bank approaches the buyer's bank with a request for a confidential report on the buyer. This is then provided to the seller in exchange for a fee.

- **Stop order**

A stop order is an instruction from a client to the bank to make a series of payments consisting of a specific amount and on a specific date to a nominated beneficiary.

- **Purchase and sale of securities**

Banks often assist their clients in the purchase and sale of listed shares

and stock. Commission is normally charged on the transaction.

- **Safe custody**

Banks accept valuables such as wills, jewellery, share certificates, contracts and deeds of transfer for safe custody, and charge commission for this service.

- **Assay**

Banks may also assist in the valuation of metals. The valuation may be done by the bank itself or by an independent assayer. Banks normally charge a fee for their services in this regard.

- **Estate and trust planning**

Banks also act as executors and trustees of estates, drawing up wills for their clients and administering the estates in due course. Their fees in this regard are controlled by the Master of the Supreme Court.

- **Electronic banking products and services**

New technology has seen the introduction of electronically based products and services available to clients, such as automated teller machines (ATMs) which use magnetic stripe cards that allow clients to withdraw cash at any time or location. Nowadays the electronic banking system facility enables the account holders to access their bank account via the internet. Clients of the bank can therefore avail themselves of this facility to perform a host of online banking transactions, for instance paying their creditors.

- **Rent income**

Banks often own the premises they occupy, and it is not uncommon for them to erect buildings providing more accommodation than is necessary to meet the banks immediate needs. Where this is the case the extra accommodation is let, and the bank receives an income by way of rent.

Villamu (2005) states that whilst bank fees make up a substantial part of bank earnings, they are a constant source of aggravation and annoyance to clients. He further states that another large source of income for banks is returns on investment and securities. In this case, the banks take some of the funds they hold and purchase other products such as shares or equity in businesses. This in turn generates profits which are received by the bank by way of dividends.

## **2.8.2 Financial crisis in the banking world**

The financial crisis in the global banking sector that the world is experiencing at present serves as an eye-opener to the world at large that the current worldwide financial system which is based on the interest system has failed humanity miserably. Many economists worldwide are reflecting on the causes and roots of the problem and this has led some of them to research the potential role of Islamic banking as providing an answer and a way out of the current crisis. The prohibition on charging interest on money lent in Islamic banking makes the Islamic and Western banking system fundamentally and structurally different from each other, for in Islamic thought business is based on capital and profit sharing. Islamic banks do not grant loans on the basis of interest, but the borrowers and lenders become shareholders instead.

According to Goud (2008) the subprime mortgage market that was the trigger for the financial crisis that started in August 2007 was sparked off by rising interest rates and a decline in property values which left homeowners and lenders

without a means to recoup their losses. Lings (2008:2), an economist at Stanlib, succinctly gives a basic five-step explanation as to how the crisis came about, based on research data obtained mainly from the Institute of International Finance in the United States. Briefly the five steps are as follows:

### **Step 1: A housing bubble was created in the mid-2000s**

Although this was evident in the US and UK markets, it was by no means confined to these economies. There were many other countries that experienced a sharp increase in house prices between 2002 and 2006 which far surpassed the growth in household income. The boom in the US was fuelled in particular by low interest rates, increased global liquidity, aggressive and innovative marketing of credit facilities, the perception that house prices would continue to rise, the incorrect pricing of risk, and a global search for higher yielding financial assets. The increase in house prices coupled with a drop in interest rates and the low level of financial regulations sparked off a boom in subprime mortgage financing. The annual issuance of US sub-prime mortgage-backed securities increased from a mere \$56 billion in 2000 to a massive \$508 billion in 2005.

### **Step 2: The US bubble started to deflate during 2006**

The bubble burst in late 2006 and this ensued as a result of higher interest rates. Houses were now no longer affordable and prices had risen way beyond the income level of prospective owners. Moreover, house prices came crashing down as a result of the slowing down of the economy, rising oil prices, rising unemployment and high inflation. Clients who were the recipients of the cheap loans could no longer afford to pay their instalments. Banks started to foreclose on bonds resulting in an oversupply of vacated houses on the market whilst the demand fell.

### **Step 3: The weakness in the US housing market led to a dramatic decline in the prices of mortgage-backed securities**

As the banks foreclosed, the securitised loans which they backed lost their value too. This became evident from August 2007, although the extent of the problem was not known at that time. The loss in the value of mortgage-backed securities and other related instruments had left many financial institutions with too little capital. The value of their assets declined relative to their debt. This problem was especially severe because most of the market participants had taken up too much debt during the bubble years. From the beginning of 2007 until the end of September 2008 banks in the US have written off \$334 billion while the European banks lost \$229 billion and Asian banks \$24 billion.

### **Step 4: Financial institutions tried to reduce their debt by selling assets, including mortgage-backed securities**

The effect of the endeavour of the financial institutions to sell off their assets had the effect to drive down prices even further, thereby worsening the banks' financial position. Some economists and market participants have termed this vicious circle the "paradox of deleveraging". Many institutions holding these loans suffered heavy losses and many faced bankruptcy. Lehman Brothers, a bank founded in 1850 which survived the Civil War, the two World Wars, the Great Depression and several business cycles, filed for bankruptcy on Monday 15 September 2008 (Financial Times 2008:1). Many other financial institutions just as prestigious as Lehman Brothers have gone bankrupt since the beginning of 2009 and many more are expected to follow.

### **Step 5: The US Treasury Secretary's \$700 billion plan was finally signed into law on 3 October 2008**

The plan known as the US Troubled Asset Relief Program (TARP) calls for the federal government to buy up \$700 billion worth of troubled assets, mainly mortgaged-backed securities, over a period of time, thereby providing much needed liquidity to the US banking system. However, according to economist Peter Moricci at the University of Maryland, the bank bail-out seems not to have had the intended effect; although the bail-out will provide banks with much needed liquidity, it does not address the compensation and management practices on Wall Street that drove irresponsible decisions and gave rise to the crisis (AFP:2008).

In spite of this, according to Khumalo (2008) South African banks are relatively safe and well protected from the US financial crisis. In his article he further quotes the chief executive of Nedbank as saying that South African banks have been protected because they generally lend to each other rather than depending on overseas lenders for financing. According to Garach (2008) American banks had granted loans too haphazardly and hence South Africans are now experiencing a temporary rebuff in the form of higher prices. However, the timely enactment of the National Credit Act 34 of 2005 acted as a protective measure on the part of the South African banks in regulating credit.

#### **2.8.3 Root causes in the banking environment that resulted in the crisis and changes deemed necessary to avoid such a crisis**

In analysing the root causes of the crisis in the light of the foregoing discussion, Usmani (2010) interestingly has identified four basic factors that sparked the crisis. He briefly summarises them as follows:

### *Diverting money from its basic function to act as a medium of exchange*

The diverting of money from its basic function to act as a medium of exchange and making it an object of trade to an unlimited extent has in fact given birth to the greed of making money out of money and has thereby turned the whole world economy into a balloon of debts over debts. In order to save the world from such negative consequences the trading of money should be stopped, the exception of course being the exchanging of different currencies for the purpose of international trade, where one currency has to be sold to obtain another currency. Moreover, one of the essential requirements for restricting money to its basic function is that interest should be abolished from the financing activities. It is therefore high time that serious attention is given to reshaping the financial system on the basis of equitable participation in productive activities so as to minimise debt transactions and further to subject them to the condition that all debts in future should be backed by real assets; simply meaning that they should be created by real trade transactions such as sale or lease.

### *Derivatives*

Usmani (2010) quotes Frank Partony on derivatives; Partony being a former derivatives trader who has stated that the financial crisis had many causes, but if a single word had to be used that best indicated the main cause, it would be derivatives. He further states that it would be in the best interest of society that derivatives be banned.

### *Sale of debts*

It has been already outlined above that the sale of debts has been one of the prominent causes of the financial crisis. It has in fact been the

packaging of large amount of debts in a bundle of collateralised debt obligations (CDOs) that was the initial cause of the present crisis, which would never had materialised if the sale of debts was disallowed.

*Short sales and blank sales in stocks, commodities and currencies*

This is the basic factor that makes speculation disastrous for the smooth operation of real commercial activities. Many regulatory authorities, having noticed the negative effects of short selling, embarked on a temporary ban on short selling. In September 2008 short selling was seen as a contributing factor to undesirable market volatility and it was subsequently prohibited by the United States Securities and Exchange Commission (SEC) for 799 financial companies for three weeks in an effort to stabilise those companies. At the same time the UK Financial Services Authority (FSA) prohibited short selling for 32 financial companies. On 22 September 2008 Australia enacted even more extensive measures with a total ban on short selling. However, these were temporary measures and some regulators restarted the practice after an interval, claiming that the ban was not proven to be in the interest of the market. This point of view was justifiable because their entire outlook on the interests of the market was based on conventional assumptions which apparently attaches more importance to the maximising of immediate profits rather than to the requirements of maintaining a sustainable welfare economy at macrolevel.

It is now high time that we look into those measures that would redesign and reshape our economy and also our economic system, making it safer, more sustainable and above all equitable for all of mankind, basing it on noble values and just principles.

#### **2.8.4 Bimetallic currency: gold and silver coin solution**

According to Vadillo (1996:51) the dollar is no longer the powerful currency that it used to be and its recent slide in value on international exchanges has dramatically demonstrated the inherent weakness of a currency supported by high interest rates. The US was once the world's leading creditor, but has now become its leading debtor. Laughland (2008) states that the US government's injection of \$700 billion as a bail-out into the financial system would actually mean that an already huge annual budget deficit of the American state (previously some \$450 billion a year) would subsequently rise by a factor of three, to a total state debt of well over \$1,1 trillion. It is obvious that such a massive debt can never be repaid; instead it will be serviced by more debt in the future. Gold can now replace the dollar as the world currency, offering unparalleled protection in relation to any other currency, for as has been illustrated above, all national currencies, including the US dollar, are simply pieces of paper; their value is as strong or weak as the country which stands behind them (Gold News 2008).

According to Rothbard (2008:4) gold is a precious metal the value of which depends on no nation or economy. Its value is intrinsic and thus trustworthy. Gold cannot be inflated by printing more of it; neither can it be devalued by government decree, and unlike paper currency it is an asset that does not depend upon anybody's promise to pay. All forms of paper assets, bonds, shares and even bank deposits are mere promises to repay money borrowed; their value being dependent upon the investor's belief that the promise will be kept (Vadillo, 1996:57). Nowadays many researchers and economists are reconsidering the gold standard as a potential solution to safeguard countries from being targeted by currency speculators. Gold and silver are the most stable currencies the world has ever seen. From the beginning of Islam until today the Islamic bimetallic currency system has remained surprisingly stable in relation to basic consumable goods (Orr & Clarke, 2009:17).

### **2.8.5 Financial turmoil: its impact on Islamic banks**

Islamic banks and financial institutions have confirmed that Islamic banks have not been affected by the global financial crisis and this is ascribed to the nature of Islamic banking: it does not deal in debt trading and distances itself from the market speculation that takes place in European and American banks (Al Hamzani, 2008:1).

Ayloush (2008) states that a growing number of economists are of the view that the global credit crunch, triggered by the subprime mortgage crisis, has sparked a greater interest in Sharia-compliant financing. As mentioned earlier, the recent and ongoing financial crisis in the banking sector has indeed served as an eye-opener to the world at large that the long-established current global financial system based on the interest system has failed mankind miserably. It is high time now for the world to look at alternatives that may be available, and one which merits attention is the Islamic finance system. At this juncture it is worth noting that at the World Economic Forum annual meeting held in Davos in 2009, many Muslim presidents, prime ministers and princes urged the world to adopt Islamic financial practices so as to solve the global crisis. An urgent appeal was made also to Islamic banks to embark on a so-called missionary campaign in the West to promote Sharia-compliant banking. The Islamic banking sector, which began almost three decades ago, has shown substantial growth and has attracted the attention of investors and bankers across the whole world. In support of this statement, Kayhan International (2008) cites the Islamic Development Bank as saying that the global financial crisis has created an opportunity that can help strengthen Islamic banking, while Sudan Vision (2008) quotes a member of the economic committee in the Sudan National Assembly, Omer Alsheikh Abdel Rahim Bakr, as having indicated that the world has implemented many economic systems that have failed and that the time has come to implement the Islamic system as a possible alternative.

In the light of the financial crisis that has adversely gripped the entire global economy and the continued dependence on charging interest as the basis of the financial system, many Muslim believers interpret the crisis as a war which God is waging on mankind and hence they regard the crisis as a warning to the world. The Quran (278-279) says: "O you who believe, fear Allah and leave any interest that is still due, if you are believers. If you do not do so then permit to face a war from Allah." US President Barack Obama has stated that the world is facing the greatest economic challenge of our time and that there is an urgent need for worldwide cooperation of all the economies of the world to address the issues of financial turmoil (SABC 2008).

### **2.8.6 Legislative impact of regulations on Islamic banks**

The elimination of the interest-charging financial system occupies a key position in the establishment of the Islamic order. Most of the policy instruments available to central banks under the banking laws of most countries would also remain largely unaffected in an interest-free system. The regulatory instruments that would remain unaffected are the following:

- Minimum cash reserve requirement
- Liquidity ratio requirement
- Overall ceilings on the lending and investment operations of banks
- Selective credit controls
- Moral suasion

Ahmed, Iqbal and Khan (1983:162) briefly discuss each of the abovementioned regulatory instruments and their exposition is followed here:

- **Minimum cash reserve requirement.** Central banks have the power to force banks to comply with a certain minimum ratio of their demand and time liabilities in cash. They also have the power to vary this ratio whenever they

deem fit. The variation in the minimum cash reserve requirement influences the ability of banks to provide finance to their clients and hence serves as an important monetary policy instrument. The central bank will be able to use this instrument also in an interest-free system, in other words the use of this requirement as a monetary instrument will not affect the functioning of an Islamic bank.

- **Liquidity ratio requirement.** In terms of banking legislation, banks are required to maintain a certain percentage of its total demand and time liabilities in the form of cash, gold or unencumbered approved securities. In terms of Section 72(1) of the Banks Act, South African banks are required to maintain liquid assets in South Africa amounting to not less than the aggregate of 20% of such different categories of its liabilities specified by regulation. This requirement ensures that banks are holding an adequate amount of liquid assets in the country so as to meet their obligations. Hubbard (2005:35) points out that the holding of liquid assets on the part of a bank serves as a safety measure for the bank itself in the event of an abnormal withdrawal of cash by depositors, and furthermore it serves as a measure to protect its depositors. It would therefore be possible to retain this liquidity requirement as an instrument of monetary policy in an interest-free system, with the only proviso that Islamic banks will no longer be able to hold on to interest-bearing securities. Islamic banks would be only able to hold on to those kind of securities that are permissible under Sharia principles.
- **Overall ceilings.** Overall credit ceilings are designed to limit the overall credit expansion by banks within safe levels of monetary and credit expansion. A bank which exceeds its credit ceiling is required to deposit with the central bank free of interest an amount equal to the excess over its ceiling until it adjust its position once more to the prescribed ceiling. No change in this system will be required in respect of Islamic banking.

- **Selective credit control.** Central banks also use selective credit control measures to regulate credit and since this does not involve the element of interest, Islamic banks will be unaffected by it.
- **Moral suasion.** Moral suasion signifies informal contacts, consultations and meetings between central bank authorities and commercial bankers to adhere to the policy guidelines of the central bank without the use of statutory control instruments. Islamic banks will remain unaffected by the exercise of this power by the central bank.
- **Bank rate.** The bank rate is the rate at which central banks are prepared to lend the banking system funds when the latter is short of liquid funds. An increase in the bank rate will have the result of curtailing credit because banks would then rediscount their bills only at a higher rate. A decrease in the rate will have the opposite effect as it will cause an increase in the demand for credit. Such upward and downward movement of interest rates will not affect Islamic banks as they do not engage in interest-bearing transactions.

### 2.8.7 Basel III and its impact on Islamic banks

The changes proposed by the Basel III committees in respect of capital requirements seem to be a step in the right direction. The Islamic Financial Services Board (IFSB) has announced a review of capital adequacy requirements in the light of the proposed Basel III requirements. The determination of capital requirements in respect of Islamic financial institutions is complicated since with Islamic financial institutions all profit and losses on the asset side are passed to the liabilities side to investors/depositors; thus the need for capital is minimised. In this mode of intermediation the purpose of capital is to cover negligence of operational risk. However, in practice capital requirements have been set for Islamic financial institutions on similar lines as that of conventional banks so as to maintain confidence of investors. An increased

capital requirement could have an impact on the efficiency and return on capital. Also the additional requirements for liquidity in Basel III will definitely put an additional burden on Islamic banks to maintain adequate capital and thus the levels of minimum capital are expected to increase (Iqbal & Mirakhor 2011:321). According to Hasan (2011:2) the majority of Islamic banks in Malaysia already maintain capital levels well above the regulatory minimum, and he cites Ramakrishnan, CEO of Oracle as stating that Islamic banks are well capitalised. This viewpoint is also corroborated by one of the managing directors of the World Bank Group, Sri Mulyani Indrawati, who states that Islamic banks are some of the best capitalised in the world and that their capital levels far exceed the regulatory requirement (Hassan 2011:2).

Basel III also incorporates the introduction of a minimum liquidity standard and the monitoring of the liquidity coverage ratio (LCR) of financial institutions. Such liquidity issues, as argued by Iqbal & Mirakhor (2011:319), have serious implications for Islamic financial institutions which they briefly outline as follows:

- Islamic financial institutions do not have access to short-term liquidity through markets. One of the biggest impediments for Islamic financial institutions (IFIs) is to develop liquid markets where securities can be traded efficiently at minimal transaction costs.
- The assets of Islamic banks are generally illiquid due to the heavy concentration of trade or commodity financing, for example Murabaha-based assets cannot be traded in the secondary market.
- Whilst conventional banks have easy access to liquidity by way of the central bank acting as lender of last resort, this is not the case with Islamic banks, since they cannot benefit from such a facility as the lending is interest based.

The above liquidity issues as set out by Iqbal and Mirakhor (2011:321) are

indicative of the fact that although Islamic banks may be in good financial health, they could still face additional capital requirements because of low liquidity which could hamper growth or efficiency.

Hassan (2011:2) states that in respect of Islamic finance there is a call for greater transparency since Islamic bank consultants stress the point that the quality of information is highly relevant to both investors and regulators. He further states that in several countries where Islamic banking is operative, the quality of information is rather low. On the same issue Iqbal and Mirakhor (2011:320) assert that enhancing the flow and quality of information could be considered as a key driver to which Islamic banks need to pay serious attention.

Insofar as the issue of risk is concerned, John (2011) highlights the point that the capital adequacy ratio (CAR) which is also called capital to risk-weighted assets ratio (CRAR) is a ratio of the bank's capital to its risk. Regulators at all times try to ensure that banks and other financial institutions have sufficient capital on hand so as to keep them out of difficulty. This of course not only protects the depositors but also the wider economy since the failure of a bank has extensive knock-on effects. Islamic finance is characterised by certain risks which are of a more diversified and complex nature than those of conventional financing, particularly with regard to return, liquidity, credit and market risks relating to Mudarabah, Musharakah and Ijara finance methodologies. According to Iqbal and Mirakhor (2011:321) the risk framework with respect to Islamic financial institutions is gradually evolving but is still in its infancy. The emphasis is currently on the managing of credit risk whilst the focus on market and operational risk is not adequate. These authors therefore assert that it is of pivotal importance that a proper risk framework for Islamic financial institutions be developed so that meaningful risk measures such as value-at-risk are developed and proper backtesting and stresstesting of exposures are undertaken in order to satisfy current and future requirements. They also underline the point that the main challenge for both supervisors and the Islamic banks will be to

develop and enhance the supervising framework. The current practice of treating Islamic and conventional banks in a similar way when it comes to supervision does not seem optimal since Islamic institutions have different contractual agreements and hence it is imperative that one understands the manner in which these contracts are drawn up. If this is not done, supervision might overlook areas of potential problems.

Basel III also incorporates macroprudential measures to help address systemic risk and the interconnectedness of financial systems; therefore regulators and supervisors need to enhance supervision of Islamic institutions. They could possibly get this done by forcing institutions to improve their internal risk systems, enhance their compliance with reporting requirements, increase the transparency of their disclosures and improve the quality of information that they put out. However, if authorities neglect to focus on these areas then they will not have a meaningful understanding of the risks that these institutions may pose to the system as a whole. Sri Mulyani Indrawati, one of the managing directors of the World Bank Group, recently highlighted the importance of Islamic financial institutions in ensuring that its regulatory and supervisory framework is consistent with global financial reforms (Islamic Finance Asia 2011:2). Also noteworthy is the comment of Mr Adnan Ahmed Yousuf, chairperson of the Union of Arab Banks, that the implementation of Basel III will not have much effect on most of the banks in the Middle East since they are already well capitalised (Islamic Finance Asia 2011:2). However, as far as Islamic Banks per se are concerned, he is of the opinion that such impacts are still hard to measure at this point in time. Yousuf nonetheless is confident of the benefits of implementing the Basel III accord, adding that whilst the short-term costs are likely to be small and transient, the benefits of a stronger and healthier financial system will be there for years to come.

## 2.9 SUMMARY

It may be concluded that banks in acting as financial intermediaries provide certain essential services for the functioning of the economy. These are the following:

- Banks collect funds from the public.
- Banks engage in the safeguarding of the funds.
- The transfer of those funds from one person to another without such funds actually leaving the bank. This is achieved by means of cheques or automatic transfers through the banking system, or via the internet, thus providing a payment mechanism through which economic units can transfer funds.
- Banks lend money to other parties for a return or reward called interest.

By extending credit, the banking system as a whole can create money. The ability of banks to create money has an important influence on investment and customer spending and consequently on general economic activity and prices. It is therefore not surprising that the extension of credit by banks is controlled by monetary authorities. Furthermore the central role played by banks in the flow of funds from savers to borrowers has a significant influence on the allocation of resources and on the efficiency with which they are used.

Banks, like other enterprises in a free market economy, are profit-seeking institutions. They are institutions whose stock-in-trade is money and that sell this money in the form of loans and other types of financial products. They derive their profits or revenue primarily from the difference between the average rate they are required to pay to depositors and the average rate they are able to charge borrowers.

The other big revenue items generated by banks are the fees that they charge for practically every service, whether it is for an electronic transaction, honouring a

withdrawal from an ATM machine, or permitting a transfer through the internet banking system.

A brief review of the financial crisis indicates that the dollar is no longer the powerful currency that it used to be and that its recent slide in value on international exchange has shown an inherent weakness of a currency supported by interest rates. Thus there is an imperative need to look at other currencies such as gold and silver which have a more stable value. Finally, in the light of the current financial crisis it appears that Islamic banks have not been seriously affected by this global crisis, which seems to be due to the nature of Islamic banking; hence the need to look for solutions within the Islamic economic system.

Whilst this chapter reviewed the conventional banking principles based on the capitalistic economic system which operates within a system of interest rates, these present a problem for Islamic banking of which the essential feature is that it is interest free. However, the functions that banks perform are important to all, whether the economy is secular or Islamic in nature. People need banking services; since these services are needed but charging or paying interest is prohibited in the Islamic economic system, it becomes imperative for Islamic banks to find alternative ways of performing the various banking functions. It is this challenge that provides the basis for Islamic banking.

The next chapter will focus on Islamic law since the ethical legal component is the most important component that distinguishes the Islamic economic system from other economic systems.

## CHAPTER 3: ISLAMIC LAW

### 3.1 INTRODUCTION

One of the most important and striking features that has gained prominence in the so-called Islamic resurgence is the need to restore the Sharia, that is, the body of Islamic law. Islamic law deals with all aspects of the day-to-day life of a Muslim, including politics, economics, banking, business law, contract law, sexuality and social issues. It cannot be denied that at present Islamic law stands out as an important cornerstone in the reaffirmation of Islamic identity.

Islam as a religion is regarded as a complete way of life, a belief system that guides a person's life in all aspects. Since this belief system is based on the guidance of God, there can therefore be no question of a person accepting God's teaching in one aspect of his life and refusing to accept it in another aspect. The Quran (16:89) clearly states the following in this respect: "And we have revealed to you in stages this book, a clarification of all things, a guidance, a mercy and glad tidings." Islam therefore has provided guidelines and rules for every sphere of life and society, including of course economics.

Islamic economics comprises a systematic study of the economic problems and challenges facing mankind from an Islamic perspective. The most important element that distinguishes the Islamic economic system from other economic systems is that it has a legal and ethical component which involves the comprehensive application of the Sharia which refers to divine guidance as set out in the Quran and embodied by the example of the Sunnah Prophet Muhammad (Peace be upon Him). It embodies all aspects of Islamic faith, including beliefs and practices in all spheres of life but with specific reference to the economic sphere.

It is also noteworthy that whilst the economic behaviour in other economic

systems continues to be influenced by some norms, morals, and ethics which have their origin in religious doctrines, the separation of the state and religion is an integral part of these systems. In Islam, however, there exists no separation between the state and religion, and the Islamic economic framework thus accepts the ethical-legal constraints prescribed by Islamic law to be binding. It therefore follows that Islamic economics is guided by the basic values of Islam and that it has its own ethical values within which it operates.

Whilst the previous chapter dealt with the conventional banking principles based on the capitalistic economic system, this chapter will focus on Islamic law in this regard, since the ethical-legal component is the most important component that distinguishes the Islamic economic system, including the banking sector, from the other systems. This chapter will hence focus on four sections: the first will provide the general framework of Islamic law, and some of the main sources from which this law emanates. The second will provide some basic definitions of general economics and Islamic economics. The third section will deal with the nature of the Islamic economic system whilst the final section will examine the Islamic attitude towards interest, referred to as Riba.

## **3.2 GENERAL FRAMEWORK OF ISLAMIC LAW**

### **3.2.1 Definition of Islamic law**

The literature on Islamic law is replete with definitions of Islamic law such as that of Ramadan (2006:3) who states that Islamic law is the “entire system of law and jurisprudence associated with the religion of Islam”. According to Iqbal and Mirakhor (2011:6) the term Sharia refers to a network of rules which represent the concrete embodiment of the divine will in terms of specific codes of behaviour according to which an individual lives both his private and social life. The term Sharia has been defined in various ways. It is etymologically derived from a root meaning “the road”; this road leads man to a harmonious life in this world and

felicity in the hereafter. Dwyer (1990:1) quotes the internationally renowned Islamic law scholar Joseph Schacht who states that “Islamic law is the epitome of Islamic thought, the most typical manifestation of the Islamic way of life, the core and kernel of Islam itself”.

According to Muslehuddin (1988:2) Islamic law is a comprehensive system covering the human being’s relationship with his Creator, with his fellow human beings and with his society and nation. However, in the event that anything essential comes to the fore, recourse may be had to the rule of necessity and need. Hassan (1970:33) refers to Islamic law as a “manifestation of God’s will”.

If Islamic law indeed comprises the entire legal system governing all aspects of life, it stands to reason that it would also cover commercial activities including finance and banking.

### **3.2.2 Salient aspects relating to Islamic law**

A succinct and informative definition of Islamic law is provided by Coulson (cited in Menski 2006:288):

Islamic law (known in some parts of the world as Muhammadan law) is a body of rules which gives practical expression to the religious faith and aspirations of the Muslim. Total and unqualified submission to the will of Allah is the fundamental tenet of Islam, and the law which is associated with the religion defines the will of Allah in terms of a comprehensive code of behaviour covering all aspects of life. All aspects of life – for ritual practices, such as prayer, fasting, alms and pilgrimage, the subject of permissible foods and styles of dress, and social etiquette generally are as vital and integral a part of the system as those topics which are strictly legal in the Western sense of the term; known as ‘ Sharia’, a derivative of an Arabic root word meaning “track” or “road”, this law constitutes a divinely ordained path of conduct which guides

the Muslim towards fulfilment of his religious conviction in this life and reward from his Creator in the world to come.

However, Rahim(1968:50) states that the law according to Muhammadan jurists is that which is established by a communion from God. Menski (2006:285) further adds that Prophet Muhammad (Peace be upon Him) was the recipient of divine messages and of course he was the first leader of the Muslim community who played a pivotal role in the process of harmonising divine revelation with social utility. An examination of the above definitions and assertions provided by the respective authors reveal certain distinctive features of Islamic law emerging. They are as follows: Islamic law -

- is a law of God constituting divine revelation
- is revealed to God's messengers
- is law which is founded on earlier scriptures
- requires no change or amendment
- is universal and holds worldwide
- is most suited to human nature
- concerns both spiritual and temporal aspects of man's life
- is the law with the fewest rules
- does not recognise the separation of church and state

Each of these distinctive features will be discussed with regard to the general framework of Islamic law.

- **Islamic law is divine revelation**

According to Usmani (2002:18) all the injunctions of Islamic law are revelations from Allah and therefore they have to be followed exactly as they are, since Allah, who is the Creator of mankind, is the legislator. As Creator, only He knows best what will be both beneficial and harmful to his creation. Allah knows the

psychological make-up of human beings and hence, if an individual being is left to his own devices to achieve true guidance by virtue of his intellect alone, he will never succeed. The Quran (4:176) states: "Allah makes clear His commandments to you, lest you go astray, and Allah is the knower of everything."

Menski (2006:285) states that the task of the Holy Prophet Muhammad (Peace be upon Him) was to explain the greatness of God's order. His works are regarded as binding, not because he was the lawgiver as such, but because whatever he said about the law had originally been conveyed to him by Allah. He is obeyed by Muslims because they are certain that his words and deeds express the will of Allah.

- **Law revealed to Gods messengers**

Shad (2001:182). asserts that since the inception of the world Allah (God) has sent from time to time approximately 124 000 prophets for the betterment of society, to cure existing evil and to guide the people to obey Allah's command. The first Prophet that was sent by Allah was Prophet Adam (Peace be upon him) and the last Prophet was Prophet Muhammad (Peace be upon him). According to Jung (2001:39) the Quran readily accepts all the previous revelations as being true and enjoins belief in them, but it condemns any infringement of the divine commandments. The four main books of laws that were revealed are the Torah (Pentateuch), the Zaboor (Psalms), the Injeel (the New Testament) and the Holy Quran. The Torah was given to Moses (PBUH), the Zaboor to Prophet David (PBUH). The Injeel (New Testament) was given to Prophet Jesus (PBUH). The Holy Quran, the final book of Allah, was revealed to Prophet Muhammad (PBUH) through the angel Jibrael. Whilst the other books were revealed instantaneously, the Holy Quran was revealed over a period of twenty-two years, from 610 to 632 CE (Ramadan, 2006:11). Authors such as Khan (1978:53) and Aslam (2006:168) hold the view that God changed, modified and repealed laws according to the

needs of society. At present the law is contained in its complete form in the Holy Quran, there being no defect or flaw in it. The law is thorough and exhaustive, in other words, the Quran constitutes complete finality on the question of laws.

- **Law which is founded on earlier scriptures**

The third distinctive feature of Islamic law is that it is founded law. According to Khan (2000: 90) the Quran is not a book in the ordinary sense of the word, but rather it refers to the book embodying the revelation from Allah to Muhammad (PBUH); hence it is commonly referred to as the Holy Quran or the Glorious Quran. In fact, Islamic law cannot be studied without studying the Quran because the Quran is the foundation of the religion. Its revelation is not subservient to the earlier scriptures since laws were changed and modified so that we now have it in its complete form. Notice the Quran's confident and unequivocal claim in this regard (Quran 5:16-18):

O People of the Scripture (Jesus and Christians)! Now has come to you Our messenger (Muhammad PBUH) explaining to you much of that which you used to hide from the scripture and pass over (i.e. leaving out without explaining) much. Indeed, there has come to you from Allah a light Prophet Muhammad (PBUH), and Plain Book (this Quran). Wherewith Allah guides all those who seek His Good Pleasure to ways of peace, and he brings them out of darkness by His Will unto light and guides them to the straight way (Islamic Monotheism).

The Quran (5:48) says:

And we have sent down to you O Muhammad (PBUH) the Book this Quran in truth confirming the scripture that came before it and Muhaymin (trustworthy in highness and a witness) over it (old scriptures). So judge among them by what Allah has revealed and

follow not their vain desires, diverging away from the truth that has come to you.

The significance of this feature of Islamic law is that it would serve for one society as for another and in one era as in another (Khan, 2000:91)

- **Law that requires no change or amendment**

Usmani (2002:18) states that it is essential that divine injunctions be followed exactly as they are, for divine law cannot be altered or modified even if the entire mankind collectively would so desire. The Quran (6:115-117) says:

And the word of your lord has been fulfilled in truth and justice. None can change his words and He is the All Hearer the All Knower. And of you obey most of those on the earth they will mislead you far away from Allah's path. They follow nothing but conjectures, and they do nothing but lie. Verily, your Lord! It is He who knows best who strays from His way, and He knows best the rightly guided ones.

The Quran (10: 15) further corroborates the above by saying:

And when our clear verses are recited unto them, those who hope not for their meeting with Us, say: "Bring us a Quran other than this or change it. Say O Muhammad (PBUH) it is not for me to change it on my own accord; I only follow that which is revealed unto me. Verily, I fear the torment of the Great Day (i.e. the Day of Resurrection) if I were to disobey my Lord".

- **Law which is universal and worldwide**

Islamic law is also universal. The Quran, according to Jung (2001:12) makes the acceptance of this universal law the foremost duty of man. The uniqueness of

Islamic law lies in its comprehensiveness of principles, valid through all ages in respect of all mankind (Latif, 2003:54). According to Shad (2001:129) God imposed the onerous duty on the Holy Prophet Muhammad (Peace and blessings of Allah be upon him) to convey God's message to the whole of mankind. The Quran (7:158) thus says:

Say (O Muhammad PBUH) O Mankind. Verily, I am sent to you all as the Messenger of Allah, to whom belongs the dominion of the heavens and the earth.

It is addressed to all mankind and not to Muslims alone and regarded as valid for all generations.

The Noble Quran (3:132) further reiterates:

And obey Allah and the Messenger [(Muhammad PBUH)] that you may obtain mercy.

It is therefore obligatory to have belief in the messengership of Prophet Muhammad (PBUH).

Latif (2003:55) further in respect of Prophet Muhammad (PBUH) asserts the following by quoting Bernard Shaw: "I have studied him – the wonderful man, and in my opinion, far from being an antichrist he must be called the Saviour of Humanity".

- **Law most suited to human nature**

Both Menski (2006:286) and Latif (2003:17) state that Islamic law is also natural law. It is the law that is most suited to human nature and the most conducive to its fulfilment and fruition. The law of God is not a harsh law nor is his will the will

of a tyrant (Latif 2003:17). The Quran (2:185) supports this view by stating: “Allah intends for you ease, and he does not want to make things difficult for you” and the Quran (2:286) also stipulates: “Allah burdens not a person beyond his scope.” It therefore makes no demand and issues no dictates which either frustrate or pervert the natural instincts and impulses of man.

The Quran (4:176) therefore rightfully proclaims: “Thus does Allah make clear to you [His Law] lest you go astray. And Allah is the All Knower of everything.”

- **Law that concerns both spiritual and temporal aspects of man’s life**

Coulson (cited by Menski, 2006:288) submits that Islamic law “constitutes a divinely ordained path of conduct which guides the Muslim towards fulfilment of his religious conviction in this life and reward from his creator in the world to come”. According to Ramadan (2006:11) Islamic law is law in its widest sense because it incorporates all aspects of human social interaction and endeavour into a single value system. It is not just a lawyer’s law or merely a priestly code but rather covers every aspect of life.

- **Law with the fewest rules**

Both Usmani (2002:139) and Ramadan (2006:29) are of the opinion that Islamic law is an open-textured law. It provides the fewest rules but on the other hand it provides numerous guidelines so as to effect justice in any individual case justly and equitably.

### **3.2.2 Sources of Islamic law**

Ramadan (2006:11), Aslam (2006:165) and Menski (2006:305) identify and briefly discuss the following as being the main sources of Islamic law. They are the following:

- Quran
- Sunnah
- Ijma
- Qiyas

Each of these sources will be discussed briefly in the following sections.

### *Quran*

The Holy Quran is a direct revelation by God brought down by the Angel Jibrael to the Prophet Muhammad (PBUH) and is recognised as being the primary source of law. The Quranic revelation continued for a the period of twenty-two years, from 610 to 632 CE. Unlike the Bible with its many books, the Quran is but one book comprising of 114 Surahs (chapters) 6 666 ayats (verses). The primary purpose of the Quran is to lay down a way of life which regulates the relationship of man with man and of man with God. The Quran gives direction for man's social life as well as for his communion with his Creator. It therefore may not be an artistic, well-arranged composition judged by the standards of the West. In fact, it does not claim to be a work of art, but rather a series of messages, directions and commandments that emanated out of a fervent mind that was divinely inspired by God.

### *Sunnah*

Sunnah refers to the practice of the Prophet whereas Hadith refers to statements or dictates of the Prophets which he pronounced. However, Ramadan (2006:11), Aslam (2006:165) and Menski (2006:305) concur that the Prophet's life was led according to the Quran. It is the Sunnah that gives concrete shape to the Quranic teachings. For instance, the Quran mentions Salah (prayer) and Zakaat (compulsory charity) but does not lay down their details. It is the Prophet who explained all the aspects to his followers in a practical form. Moreover, the Quran made obedience to the Prophet obligatory; hence the Sunnah that represents the

model behaviour of the Prophet, be it in the form of precept or example, became ultimately a source of law.

#### *Ijma (Consensus)*

The third source of Islamic law is known as the Ijma. It is the consensus of either the community or the religious scholars (Ulemas). These Ulemas are consulted on many matters, both personal and political. When the Ulemas reach a consensus on an issue it is interpreted as Ijma. The concepts and ideas found in the Ijma are not found explicitly in the Quran or in the teachings (Sunnah) of the Prophet Muhammad (PBUH).

#### *Qiyas (Analogy)*

Qiyas is the fourth element of Islamic law. Qiyas is an individual form based on analogical deduction. Qiyas is not explicitly found in the Quran, Sunnah or given in the Ijma. The Qiyas are new cases or case law which may have already been decided by a higher judge. The Sharia judge can then use the legal precedent to decide new case law and apply it to a given problem. The judge, for instance, could use a broad legal construct to resolve a very specific current issue; for example, a computer crime or theft of computer time is not found in the Quran or Sunnah. The act of theft as a generic term is prohibited so the judge must rely on logic and reason to create a new case law.

### **3.3 SOME BASIC DEFINITIONS OF ECONOMICS AND ISLAMIC ECONOMICS**

Man has been in a state of economic confusion from the time that he was born, his prime concern being to determine the ways and means in which he could satisfy his basic needs. The world today could be said to be divided into two major economic ideologies, namely the capitalistic and communistic ideologies. However, none of these ideologies seem to have given mankind the peace and tranquillity which is so urgently needed. Few will therefore disagree that the world economic situation is in need of a new approach that would possibly address the

underlying problems that face it. The call for such a new international economic order has been repeated often enough but an integrated, realistic and visionary approach has yet to be adopted by the international community. One approach which merits serious consideration is the Islamic economic system (Muhammad 2010:67-70).

### **3.3.1 Economics defined**

To create a context, it is useful to start with some definitions of modern economics by leading authors. According to Samuelson and Nordhaus (2001:41) “[e]conomics is the study of how societies use scarce resources to produce valuable commodities and distribute them among different people”. Pape (2000:7) states that “economics is the study of production, distribution and consumption of goods and services in society”. Welch and Welch (2004:2) on the other hand define economics “as the study of how scarce or limited resources are used to satisfy people’s unlimited wants and needs. In other words economics is concerned with how people make decisions in a world of necessity”.

### **3.3.2 Islamic economics defined**

According to Al Qardawi (2004:176) the economic system of Islam covers the economical, political and social fields of the Muslim community and will be beneficial if it is run on the basis of the Holy Quran and the Sunnah. Khan (1983:19) is of the view that Islamic economics is based on a belief system which guides and governs the structure and operation of various relations and institutions. An examination of both categories of definitions by any student of economics would reveal certain distinct differences. Whilst modern economics only confines itself to the study of mankind in the ordinary business of life, Islamic economics on the other hand study man as a social being submitting himself totally to Islamic norms and values. Viewed therefore from an Islamic

perspective, economics may be defined as the study of man as Allah's vicegerent and trustee in the fulfilment of his obligation to utilise the resources of creation in the service of Allah and mankind. The nature of any economic system today is based upon certain conceptions of life, about man and his position in the universe. The economic system of Islam, like its laws and orders being relevant to all other social disciplines, can rightfully be called universal law (Al Qardawi, 2004:VII).

Khan (1983:18) highlights certain interesting characteristics of both the capitalistic economy and Islamic economy, which will be discussed here briefly.

### *Capitalistic economy*

The following characteristics are typical of this economic system:

- On a conceptual level, the basic assumptions and the value system of capitalism are alien to the basic precepts and societal norms of Islam; for example, in capitalism material acquisitions are held in high esteem whilst material deprivation is rated socially undesirable.
- Capitalism presumes that all human beings are inherently selfish and whilst taking useful decisions in pursuing this selfishness they arrive at a socially desirable equilibrium. An "invisible hand" directs the natural forces in the economy to solve the problems of the economy. Islam thought disagrees with the assumption that man is inherently selfish; in fact, the Quran (96:4) informs us that man has been created with the best frame and nobility of character. Selfishness and a lustful craving for wealth is actually an indication of his degeneration and he can once again regain his initial sublimity by fulfilling his commitment to God and society. In contrast to this, capitalism has taken selfishness in man to be part of his nature.

- The material values of capitalism are free from any moral constraints. Individuals have much freedom to decide, to believe and act in any manner as long as they do not infringe another person's right to a similar freedom. It is in this absence of moral constraints that the acquisition of material possessions becomes the sole purpose of people's life and existence. To remain a contented and satisfied being is not only a function of what one has but also of what others have. The unequal income distribution coupled with the craving to keep up with one's social peers constantly keeps a person in a state of unhappiness. This is the result of a system where an individual has so much freedom as set out above.
- The right to own and utilise property is absolute in capitalism. Sole ownership of property rests with the owner who of course has an uninhibited right to its fruit.

#### *Islamic economic system*

- The economic system of Islam is based on a belief system which guides and governs the structure and operations of various relations and institutions.
- Islam disagrees with the assumption that man is inherently selfish.
- Freedom of enterprise in Islam has been visualised in a framework of socioeconomic rules.
- Islam does not recognise an absolute right to own property nor does it grant an uninterrupted right to utilise property.

The main difference between the capitalistic economy and the Islamic economy lies in the fact that the capitalistic economy is based on maximisation of profits by

any means where the gap between the rich and poor continues to increase. The exploitation of people is one of the side effects of the system. There is no interference of religion in the economy and in fact they are regarded as two separate issues altogether. The Islamic economic system on the other hand is based on the Sharia, that is, Islamic law, that governs both the secular and the religious activities of man where the basic objective is to ensure the general human wellbeing and socioeconomic justice between man and man.

### **3.4 DISTINCTIVE FEATURES OF AN ISLAMIC ECONOMIC SYSTEM**

Badawi (2005:15), Al Qardawi (2004:25), Religion of Islam (2006) and Khan (1983:12) have identified certain distinctive features of Islam, which will be discussed briefly.

#### *Belief in God*

The first conception is that everything has to start from the belief in God as the Creator; Lord and Sovereign of the universe. This implies the willingness to submit to God's will, to accept his guidance and to have complete and unqualified servitude to Him. It therefore follows that Muslims do not imitate or emulate any other system if it differs from their particular principles, for example the system of usury or interest.

#### *Complete way of life*

Islam as a religion is a complete way of life which guides a person's life in all aspects: moral, social, ethical, economical, political, etc. All this is based on the guidance of a person, who cannot accept God's teaching in one matter and refuse to accept it in another. Everything has to be within the norms of basic guidance. The Quran (16:89) states:

And we have sent down to you the Book [the Quran] as an exposition of everything, guidance, a mercy, and glad tidings for those who have submitted themselves [to Allah as Muslims].

*God created human beings on earth as his trustees*

God has created human beings on earth as his trustees; in other words, everyone is entrusted to fulfil a certain responsibility on this earth. God in his infinite mercy has endowed human beings with a free will in order for them to live their lives according to the dictates of Islam.

The Quran (7:10) says in this regard: “And surely, we gave you authority on the earth and appointed for you therein provisions [for your life] little thanks do you give.”

Natural resources have been created by God as gift to mankind as a whole, to be shared on an equitable basis. Hence their exclusive control by individuals or groups is not consistent with the Islamic ideal. This therefore is the basis of the Islamic doctrine of man’s trusteeship of God’s gifts.

*The physical world and its relationship with man*

The physical world has been created to serve a divine purpose. The entire universe has been created by one God to serve a divine purpose. God has chosen man as his vicegerent on earth endowing him with all the necessary facilities to develop the resources of earth. In the words of the Quran (44:38-39):

And we created not the heavens and the earth, and all that is between them, for mere play. We created them not except with truth (i.e. to examine and test those who are obedient and those who are disobedient and then reward the obedient ones and punish the disobedient ones), but most of them know not.

Further corroboration for this is found in the Quran (45:12-13; 67:15):

Allah, it is He who has subjected to you the sea, that ships may sail through it by His command, and that you may seek of his bounty, and that you may be thankful. And he has subjected to you all that is in the heavens and all that is in the earth, it is all as a favour and kindness from Him. Verily, in it are signs for a people who think deeply.

He it is who has made the earth subservient to you [i.e. easy for you to walk, to live and cultivate it], so walk in the path thereof and eat of His provision. And to Him will be the resurrection.

Thus humans are encouraged to enjoy the good things that God has created but they are to do so within the boundaries that He has given.

#### *Principle of accountability*

God has given human beings trusteeship and resources; hence it stands to reason that every single person will be questioned on the day of judgement as to how he utilised God's resources and behaved in his earthly life.

The Noble Quran (6:62) states:

Then they are returned to Allah, their True Maula (True Master (God) the Just Lord (to reward-them). Surely for Him is the judgement and He is the swiftest in taking account.

#### *Variation in wealth is merely a trial*

Variation in wealth among people does not in itself render a person either

superior or inferior. A state of poverty or of affluence is in the total control of God. The Quran (13:26) says: “Allah increases the provision for whom He wills and straitens [it for whom He wills].”

Affluence is also seen as a trial from God, as can be deduced from the Quran (64:15): “Your wealth and your children are only a trial, whereas Allah! With Him is a great reward [Paradise]”.

God’s yardstick in measuring the success of man is not by virtue of the wealth that one might have amassed but rather through the piety of one’s heart. The Quran (49:13) says:

Verily, the most honourable of you with Allah is that [believer] who has At. Taqwa [i.e. he is one of the Muttaqun (the pious)]. Verily Allah is All knowing, All aware).

### *Acquisition of wealth*

The Islamic economic system’s notion of wealth is not that it should be seized by all possible means, but that there should be an element of sharing in it with the underprivileged. The Quran (4:29) enunciates this principle in the following verse:

O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. And do not kill yourselves (nor kill one another). Surely, Allah is most merciful to you.

The notion of trade in this verse refers to exchange of goods and services for money. By imposing the condition of “mutual consent”, forms of exchange have been declared illicit when they involve coercion of any sort, deception, misrepresentation or intrigue, which if it were known would have deterred the other party from consenting to the exchange.

The Quran has also taken cognisance of the fact that man is greedy (4:128), impatient (70:19) and violent in his love for wealth (100:8). Islam has endeavoured to subject this instinct to a moral objective in order to restrain greed. Islam does not give an open licence to its followers to gain wealth, but in order to safeguard the corporate interest sets up a distinction between lawful and unlawful gain. Hoarding of wealth is also condemned from the Islamic point as it stops the circulation of money and increases imbalance in its distribution (cf. Quran, 3:180). Islam enjoins spending, yet it forbids squandering of money and luxury living. The Quran (17:26-28) states that the giving away of wealth by way of charity to the poor and needy is one of the most frequently repeated exhortations in the Quran. Islam enjoins on all Muslims to pay Zakaat (compulsory charity) amounting to two and a half percent of their capital that has been amassed for a year to the less fortunate. In so doing a Muslim earns God's blessing, mercy and forgiveness. It is a kind of social security system that taxes the wealthy in order to support the needy. Moreover, the payment of Zakaat reduces poverty and closes the gap between the haves and the have-nots. It is a highly beneficial aspect of any fair, just and equitable economic system.

It can be seen from the above principles that the Islamic economic system is based on principles that are radically different from other systems in the world. The distinctive features of an Islamic economic system could be summarised as follows:

- **It is the belief in God.** Allah is the Creator and Sustainer of the universe and the heavens. A Muslim must believe unambiguously and without reservation that God is One and that there is no God but Him.
- **Islam is a complete way of life.** Man's entire individual and social life is an exercise in developing and cementing his relationship with God.

- **God has created human beings on earth as his trustees.** Everyone is entrusted to fulfil a given responsibility on earth.
- **The physical world created by God is to serve a divine purpose.** We are encouraged to use and enjoy the God-given gifts within the boundaries stipulated.
- **The principle of accountability is of paramount importance.** In Islam, being God's vicegerent or trustee, one will have to account to God on the day of judgement as to how one utilised God's resources.
- **Variation in wealth.** This is merely a form of trial and does not in itself assume superiority or inferiority.
- **Acquisition of wealth.** In Islam this does not mean that it should be seized by all possible means, but rather that there should be an element of sharing with the underprivileged.

It is also important to bear in mind that in the examination of any issue in Islam, be it economics, politics, banking, divorce, marriage, etc. one has to examine it within the framework of the abovementioned Islamic economic principles.

### 3.5 ISLAMIC ATTITUDE TOWARDS INTEREST

According to Iqbal and Mirakhor (2011:58), the word Riba (interest) refers to an increase or addition. Technically it denotes any increase or advantage obtained by the lender as a condition of the loan. Any risk-free or "guaranteed" rate of return on a loan or investment is considered to be Riba, and in all its forms this is prohibited in Islam.

Suleiman (2005:4) refers to Riba as an addition to the amount of the principal

loan amount according to the time for which it is lent and the amount of the loan. He also highlights the point that whilst earlier there was much debate as to whether Riba actually refers to interest or usury, it now seems to be a settled issue by way of consensus of opinion amongst Islamic jurists that the term extends to all forms of interest.

The abovementioned definitions of interest have also been corroborated by a student of Darul-Uloom (a learning centre for students intending to pursue higher studies in Islam in the United Kingdom) that interest means excess, or increase (Inter-Islam 2001). He further elaborates by stating that in Islamic terminology interest means “effortless profit” or “that profit which comes free from compensation or that extra earning obtained that is free of exchange”. The student further quotes renowned scholar and leader Hazrat Shah Waliullah Dehli who gives a very concise and precise definition of interest: “Riba is a loan with the condition that the borrower will return to the lender more than and better than the quantity borrowed”. Allahuakbarnet (2007) also supports the same view of the student of Darul Uloom that Al-Riba in the Arabic language means “excess” or “increase”.

El Gamal (2006) is of the opinion that Riba means “to increase” and hence he asserts that jurists define the forbidden Riba generally as “trading two goods of the same kind in different quantities, where the increase is not a proper compensation”. However, Yusuf Ali (cited in Ramadan, 2006: 6) maintains that Riba is any increase sought through illegal means, such as usury, bribery profiteering and fraudulent trading. An examination of the definitions of Riba by the various authors and writers mentioned above reveal Riba as comprising at least the following elements:

- Excess or surplus above the loan capital.
- The determination of this surplus in relation to time.
- Stipulation of this surplus in the loan agreement.

The Quran (2:274) states the following: “God hath permitted trade and forbidden usury.”

The three abovementioned elements jointly constitute Riba and any deal, bargain or credit transaction in money or in kind which constitutes these elements is considered as Riba by Muslim jurists. The above elements of Riba can be identified in the meaning of both the words interest and usury, since these words have similar meanings and are characterised by the addition or excess paid (or received) over and above the loan capital. Without making any distinction between interest and usury, Islam prohibits Riba, which is of course, a very wide term which includes both interest and usury.

Contrary to the Islamic position, Hawkins(1998:493) defines usury as the lending of money at an excessively high rate of interest; however, Mannan (1970:218) contends that it is difficult to distinguish an “exorbitant” rate of interest from a “reasonable” rate and substantiates this by saying that what might be viewed as being reasonable in one country at one time, might be unreasonable in another country at a different time. He further refers to instances in some countries where two institutions granting similar types of loans might consider the other’s legal rate of interest as exorbitant. To substantiate his argument, he takes the example of the US where a bank at one time was not legally allowed to charge more than 8% interest. Whilst this applied to a bank as finance company, another credit provider was permitted to charge up to 36% interest per annum for a similar type of loan. In connection with a personal loan, moneylenders were at liberty to charge anything from 24% to 100% interest per annum and this was still considered as keeping within the confines of the law. On the basis of this reasoning I agree with Mannan who concludes that there is no difference between interest and usury on the one hand or Riba on the other hand. The stance taken by Islam is more clear and enlightening as it puts a halt to all sorts of moneylending. Islam thus propagates charging a zero rate of interest

(Abdullah Bin Baz, 2002:10) as its legal rate and any rate above the zero rate is considered as a usurious rate.

### **3.5.1 Riba in the Quran**

The definition of interest has already been discussed, and it has been shown that it is prohibited. There are four places in the Quran where interest is mentioned; these will be discussed here briefly.

In the first place the Quran (2:275-279) says:

Those who eat Riba [usury] will not stand [on the day of Resurrection] except like the standing of a person beaten by Satan leading him to insanity. That is because they say: trading is only like Riba whereas Allah has permitted trading and forbidden Riba .

This admonishment was revealed near the completion of the Prophet's mission, severely reprimanding those who take Riba, and establishing a clear distinction between trade and Riba.

In verse 276 the Quran says:

Allah will destroy Riba and will give increase for Sadaqat [deeds of charity, alms etc.] and Allah likes not the unbelievers, sinners.

This revelation makes it clear that Allah is not in favour of usury but of acts of charity benefiting man.

In verse 278 the Quran states:

O you who believe! Be afraid of Allah and give up what remains [due to

you] from Riba from now onwards if you are [really] believers.

In this revelation God commands those who have any outstanding amount of interest due to them to forego this if they fear Allah and take only the principal amount.

In verse 279 the Quran indicates retribution or reward by stating:

And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly [by asking more than your capital sums] and you shall not be dealt with unjustly [by receiving less than your capital sums].

In this verse Allah proclaims that if one does not do as commanded then Allah warns of a war being waged by Him and his messenger against the guilty party, while those who obey Allah would be rewarded through His grace.

In the second place, the Quran (3:130) says:

O you who believe! Eat not Riba doubled and multiplied, but fear Allah that you may be successful.

Muslims are thus commanded to abstain from Riba if they wish to prosper in the comprehensive sense.

In the third place, the Quran (4:161) asserts:

And their taking of Riba though they were forbidden from taking it and their devouring of men's substance wrongfully [bribery]. And we have prepared for the disbelievers among them a painful torment.

The interpretation of the Quran here is that Riba was already prohibited in the previous scriptures, but people disregarded the prohibition and hence a warning of a painful punishment is issued to the transgressors.

In the fourth place, the Quran (30:39) states the following:

And that which you give in gift [to others], in order that it may increase [your wealth by expecting to get a better one in return] from other peoples' property, has no increase with Allah, but that which you give in Zakaat [Sadaqa: (charity etc.) seeking Allah's countenance, then those, they shall have manifold increase.

It emphasises that while charging interest will deprive one of God's blessing of wealth, practising charity will increase God's blessing.

### **3.5.2 Distinction between Riba and profit**

The Quran itself recognises the notion of profit. The chief argument advanced by the non-believers of Arabia against the prohibition of interest in their countries was that "trade is similar to Riba". In fact they argued that the additional charge on cost incurred in trade is similar to the additional levy on amounts lent out. However, the Quran (2:275) clearly states the following: "Allah hath permitted trading and forbidden Riba."

This assertion maintains that an increase in wealth earned through trade is quite different from the one exacted through loans. The former is permissible whilst the latter is not. For those who long to earn profit, the avenues of trade and business partnership have been thrown open; in fact, Prophet Muhammad (PBUH) himself accompanied his uncle Abu Talib to Syria on trading expeditions to Aslam (2006:20).

Iqbal (2001:18), however, avers that the difference between profit and interest lies in the fact that profit is not predetermined whilst interest is predetermined and hence in respect of loans the lender will always be on the gaining side. From the aforesaid it may be deduced that borrowed capital upon which interest is charged may not be used in business but risk capital is permissible. Risk capital entails the possibility of either profit or loss of a non-predetermined value. In respect of rent and interest it can be argued that whilst rent for leasing of property is permissible although this is predetermined, but rent on loans, which is also predetermined, is not permissible. Phalwarwi (1959:17) draws an analogy between rent and interest in which he points out the following:

- Property which is hired out on rent does not lose its identity whilst money loses its identity before it is brought into use. He further stresses the point that it is an established law of Sharia that rent is lawful for those articles which maintain their identity during use and hence perishable goods cannot be lent out on rent and likewise money cannot be hired out on rent.
- The benefit that is drawn from leasing property by a tenant is practically certain whilst the productivity of capital is uncertain.
- Property depreciates during its use and is also subject to natural calamities, whilst money remains safe and sound. Rent is thus regarded as a reward for the wear and tear.

Other writers like Khan (2006:8) stress the point that the cardinal principle that guides Islamic transactions is the fact that only assets may earn a return due to their intrinsic utility and productivity; however, money in itself does not represent an asset and the mere holding of money, or its trading over time does not justify the earning of a return. It follows from the viewpoints expressed by the above writers that though interest and rent are essentially similar in substance they are

somewhat different in form and that seems to be the crucial determinant factor that comes into play in determining permissibility and nonpermissibility. Accordingly it follows that the hiring out of property which is a real asset and the resultant earning of rent on it is permissible whilst the earning of interest on a loan is prohibited.

### **3.5.3 Effect of Riba (interest) on an economy**

Usmani (2001:88), Khan (1983:44) and Mannan (1970:167) highlight some of the effects Riba has on an economy. Briefly they are as follows:

- **Interest and capitalism**

Interest has given rise to a capitalist group of individuals in societies. When a group of individuals invests their own funds together with the funds of other people they ensure the greater share of production for themselves. The capitalists tend to satisfy the real contributors of capital with security and small amounts of interest. This enables them to control employment and to pocket the entire return they get out of the enterprise, which is often done at the expense of those very factors of production which placed their capital at his disposal.

- **Interest hampers real economic activities**

Interest prevents people from undertaking real economic activities. This is because those people earning money earn more money on the basis of interest thereby breeding a nation of lazy individuals who do not engage in real economic activities (El Ashker, 1987:41).

The underlying principle that seems to emerge from the above is that capital accumulated through effort, initiative and risk in a productive venture is more

important than the money used to finance it. Islam encourages investment so that the community may benefit and not the hoarding or lending of money in return for an increase in those funds without taking risks.

- **Interest forms a component of production**

An entrepreneur who has to pay interest adds a multiple of the rate of interest to cover repayment of interest, principal debt and also the risk of going bankrupt. The rise in the cost of production increases the price level which impacts adversely on the purchasing power of people. This results in a fall in consumption, investment and employment.

- **Interest-based loans primarily in favour of wealthy**

Interest-based loans have a persistent tendency to favour the rich and impact negatively on the interest of the common people. In the present banking system loans are advanced mainly to those who on the strength of their wealth can offer satisfactory collateral.

- **Interest and trade cycles**

There seems to be consensus of opinion among economists that interest is a cause of trade cycles in the economy (Mannan, 1970:170; Chapra, 1983:23; Qureshi, 1974:134).

- **Interest and debt-servicing problems**

Interest puts the majority of mankind under the slavery of debt. Once interest is allowed and ordinary loans in essence become a form of profitable trade, the whole economy turns into a debt-orientated economy. At this juncture it is worthwhile noting the comment of president Obasanjo of Nigeria, speaking in

the year 2000 on the matter of his country's debt to international creditors (cited in Muslim News 2007): "All that we had borrowed up to 1985 or 1986 was around \$5 billion and we have paid about \$16 billion yet we are still being told that we owe about \$28 billion. That \$28 billion came about because of the injustice in the foreign creditors' interest rates. If you ask me what is the worst thing in the world I will say it is "compound Interest". Muhammad(2007)

- **Interest and slavery**

According to Mannan (1970:172) interest has the capacity to throw most of mankind into the slavery of debt. In a public debate held on 11 April 1921 in Wagner Hill, Munich, the German Federation For The Abolition of Interest Slavery proposed that the solution to the country's economic crisis could only found by getting the lender of funds to share in the risk as well as the profits and that the lender should not receive a blanket guarantee of his principal sum lent out together with fixed interest. The Federation emphasised the point that banks as lenders of funds were the sole culprits promoting this form of slavery as they lent money at high interests rates thereby enslaving the borrowers by charging interest and as a result effectively taking command of their economic life. It therefore proposed that it was only by abolishing interest slavery that Germany would achieve reconciliation between lenders of funds and borrowers of funds in a nation torn by conflict.

- **Interest and the free market**

Interest is the most destructive force at work corrupting and destroying the free market. Khan (1983) asserts that one of the features of capitalism is the protection and maintenance of a free market in which prices are determined by the forces of supply and demand without any market interference. In fact he stresses the point that on one occasion Prophet Muhammad (PBUH) declined to interfere in the market price which had gone up considerably. The

implementation and the imposition of interest is therefore regarded as interference in a free market system. When governments wish to stimulate the economy, one of the strategies that they implement is the lowering of the interest rate. The repercussions of such a decision is well substantiated by Polleit (2007) when he states that business takes advantage of the lowered interest rate by investing in new equipment, hiring additional staff, buying new raw materials and building up inventories; hence the production of investment goods expand relative to consumer goods. Consequently there is a false impression of an economic boom in the minds of investors who continue going on an investment spending spree as a result of the prevalent low interest rate but which cannot be sustained under existing conditions. The additional investment therefore leads the economy down a path that is not sustainable in the long run. Businesses soon begin to fail, investment projects are abandoned and liquidations and unemployment levels increase. This is followed by an economic downswing. It can also be argued that in certain circumstances state interference in a free market system where great economic power is vested in the hands of a few selected individuals could result in the manipulation of prices and these individuals could use this to distort the market price to their selfish ends; for example, businesses could cooperate with one another by stockpiling to bid prices, or by creating demand by using false and untrue advertisements.

- **Interest and world peace**

Interest on loans can stand in the way of creating a better world to live in, since the needs of the “have-nots” in society give rise to the necessity for the acquisition of loans and it is the society of “haves” who can afford to advance loans to the “have-nots”. The charging of interest on loans by the “haves” could result in antagonism and hatred on the part of the “have-nots”, who could construe it as exploitation. This type of exploitation in either in domestic or international sphere would inevitably lead to domination by exploiters and

develop into a potential threat to peace. Chapra (1983:22) is of the view that the social and economic gulf between the rich and the poor would increase as a result of this and some of the primary needs of the poor, such as food, clothing, education, medical aid and housing would become more difficult to satisfy. The net effect of this would be that social solidarity weakens and society degenerates with an increased manifestation of symptoms of frustration, such as crime, alcoholism, alienation between parents and children, mental illness and suicide. Of course, that which is applicable on the national level is also applicable on the International level.

### **3.5 SUMMARY**

Islam as a religion is considered a complete way of life which guides a person through all aspects of his life and is based on the guidance of Allah (God). The fundamental tenet of Islam could be summarised as the total and unqualified submission to the will of Allah, which can be defined in terms of a comprehensive code of behaviour covering all aspects of life. The main sources of Islamic law are the Quran, Sunnah, Ijma and Qiyas. Muslims recognise the Quran to be a direct revelation by God, brought down by the Angel Jibrael to Prophet Muhammad (PBUH) and thus the Quran is recognised as the primary source of law. The Sunnah is a reference to the practice of the Prophet, whilst Hadith refers to the statements or dictates of Prophet Muhammad which he pronounced during his lifetime. Ijma is the consensus of opinion of religious scholars on certain contentious political and personal issues not found explicitly in the Quran or in the teachings of Prophet Muhammad (PBUH). Qiyas, the fourth element of Islamic law, is based on logical analogical deductions.

The chapter has highlighted the differences between modern economics and Islamic economics; the main difference being that whilst modern economics on the one hand confines itself to the study of mankind in the ordinary business of life, where the maximisation of profit ranks as top priority, Islamic economics on

the other hand studies man as a social being who is submitting himself wholly to Islamic norms and values based on the Sharia or Islamic law, which governs both the secular and the religious activities. It is in fact this that makes the Islamic economic system fundamentally different from the conventional economic system. The examination of what constitutes Riba (interest) is important since interest is an integral component of the conventional banking system, indeed of central importance, but it is excluded in the Islamic economic system. This exclusion makes the envisaged Islamic economic system and Western economic system structurally different from each other. It is conceivable that many of the economic ills of our age can be traced directly or indirectly to the charging of interest. In fact, Orr and Clarke (2009:160) assert that most businesses are indebted to the hilt. Bankruptcies are at an all-time high and more money is spent on servicing corporate debt than is paid out to shareholders in dividends. The whole world economy today is in a state of global recession. Stock markets are collapsing across the world, individuals and public institutions such as pension funds are seeing their wealth disappear faster than ever, and governments incur debts at an alarming rate. In this environment any new approach would need to confront the problems directly and seek solutions in Islamic doctrine and experience. Also pertinent to mention at this juncture is the comment made by the Vatican in their official newspaper, the *L'Osservatore Romano* (cited in *Business Day* 2010) that if the principles of Islamic finance are implemented, it may prevent the continuation of the recession. The *Business Day* article further mentions the opinion of Italian economists Loretta Napoleoni and Claudia Segre, who suggested that conventional banks should adopt the ethical rules of Islamic finance so as to restore confidence among their clients and shareholders. These economists went further to state that it is in fact the ethical principles on which Islamic finance is based that may bring banks closer to their clients and to the true spirit which should mark every financial service.

It is the abolition of interest that has become the hallmark of Islamic economics

in modern times. It is also in this area where the greatest challenge lies for Islamic economists. They will have to justify the abolition of interest by way of a fresh analysis of money and its role in the economy and present an operational model of interest-free banking which of course will have to be a trade-based model in accordance with Islamic Sharia which would convince modern man that the Islamic banking system would be a more just and viable alternative.

The next chapter will deal in detail with Islamic banking principles and other related issues associated with Islamic banking.

## CHAPTER 4: ISLAMIC BANKING

### 4.1 INTRODUCTION

One of the most important and fundamental changes that have arisen in the wake of the Islamic transformation of a modern economy is the eradication of the interest factor by institutions whose statutes, rules and procedures expressly state their commitment to the principles of Islamic law (Sharia).

The essential feature of Islamic banking is that it is interest free and the main principle guiding these banks is that those who lend money should participate in both the profits and losses of the borrowers according to a proportion agreed upon beforehand by the parties to the contract. It follows that this trend of banking is essentially based on the principles of profit and loss sharing (PLS) which allows for conformity to Islamic ethical principles. To claim a pre-determined positive return on money capital is considered unjust by Islamic principles. Islam severely condemns injustice and exploitation and gives top priority to the attainment of human, economic and other relationships on the basis of justice and cooperation. The Islamic banking system therefore has an explicit values-orientated framework based on human needs and ideals.

This chapter is divided into four sections. Section one will draw from the Islamic economic principles in order to identify the fundamental principles on which Islamic banking is based. Furthermore, the profit and loss sharing (PLS) system as the ethical basis for contemporary adaptations will also be dealt with in this section. The discussion will revolve around the various types of PLS contracts that are used by Islamic banking institutions for project finance and investment purposes.

Section two will deal with the PLS system and its institutional and operational issues. The discussion will revolve around issues such as the establishment of

Islamic banks, the sources of capital, and bank earnings.

Section three will deal with the Islamic banking movement as it started off in different countries, and section four will review the profile and operations of some Islamic banks in practice.

## **4.2 ISLAMIC BANKING PRINCIPLES**

In dealing with the Islamic banking system there are two important factors that should be borne in mind. Islamic banking firstly entails an integral component of the whole conception of life impacting both on the individual and on the whole community. Islam secondly provides for adaptation in accordance with the needs of a changing social and physical environment. The Islamic banking system hinges on a number of fundamental principles, some of which are stated in Nida-ul-Islam (1995), At-Tijaarah (2007) and Maurer (2005:30). The main issues involved, as they become apparent from the work of these authors, are briefly reviewed below.

- **Any predetermined payment over and above the actual amount of the principal debt is prohibited**

According to Khan (2006:4) Islam permits only one kind of loan, known as being Qard-al-Hassan (literally: a good loan) in which case the lender charges no interest or additional amount over the money lent. In fact, even any associated or indirect benefit is prohibited. However, Khan (1983:107) emphasises the point that in respect to the so-called good loan, it is given to a consumer only to meet his primary or essential needs; it would never be provided to the consumer to meet his luxury needs.

- **Social justice and redistribution of wealth**

The accumulation and creation of wealth is seen as oppressive by the less fortunate members of society and as entrenching the dominance of the rich. In Islamic thought, wealth creation without the corresponding social responsibility and charitable activities is regarded as vulgar at best and inhumane at worst. In Islam accumulated wealth is subject to Zakaat (an obligatory tax to be paid to the poor by all wealthy Muslims). This acts as an automatic wealth redistribution system distributing wealth from the rich to the poor. Muslims therefore need to be aware of the tremendous inequalities that exist in society, and should realise that the possession of wealth brings with it the added responsibility to address the social ills facing society.

- **Investments should only support practices or products that are not forbidden**

Investments should be allocated in such a way so as to ensure the fulfilment of legitimate needs. Therefore there should be a balance in the development of economic life covering all aspects of life. An Islamic bank would not finance trade in alcohol nor would it make a real-estate loan for the construction of, for example, a casino. Such a bank also cannot lend money to other banks and charge interest on it. With regard to interest, Islamic banks may also transact with other banks and maintain accounts with such banks, including the meeting of certain requirements like maintaining cash reserves with the South African Reserve Bank. However, Mahmoud Youssef Baker, the director of Albaraka Bank in South Africa, states that according to an opinion of an Islamic scholar the interest earned on such funds cannot be distributed to the shareholders or used by the bank (Mail and Guardian, 2012). The income from interest is used to support all kinds of humanitarian initiatives; however, the bank cannot benefit from the money in any way.

- **The hoarding of money is prohibited**

The principle which emerges is that Islam encourages investments in order for the community to benefit. God-given resources are meant to be used for one's own benefit as well as for the benefit of others. Hoarding of wealth is unequivocally condemned in Islam. The Quran (9:34) says: "...and those who hoard up gold and silver and spend them not in the way of Allah announce unto them a painful torment."

- **God provides man with the means of living**

The Quran (4:131) says: "And to Allah belongs all that is in the heavens and all that is in the earth." This verse of the Quran makes it quite clear that the entire universe is created by one God and thus He is the owner of all the resources of the earth and it is He only who provides man with the means of living. The Quran (6:165) also says: "And it is He who has made you generations coming after generations replacing each other on the earth." Allah has endowed man with the facilities to develop the resources of the earth.

- **The lender must share in the profits or losses arising out of the enterprise for which the money was lent**

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. In banking terms the depositors, the bank and the borrower should all share the risks and the rewards of the business venture as contrasted with the interest-based commercial banking system in which all the pressure is on the borrower who must pay back his loan with the agreed amount of interest regardless of the success or failure of his venture.

- **The moral imperative**

Trust in others and faith in the community is the foundation of Islamic banking within the framework of the Sharia (Islamic way of life). It is the duty of individuals to pursue their economic interests in accordance with these rules of conduct. Overall the emphasis is on individual wealth ownership where this wealth has originated from the application of effort. Human capital (education) is seen as a key input and the underlying economic value system is the labour theory of value that emphasises value in use, rather than value in exchange. Owners of capital must share the risk of a venture on an agreed basis with owners of labour; without this risk sharing, owners of capital have no right to appropriate any of the output from the productive effort. Reward only accrues where a factor has performed a service, and risk bearing is an essential feature of the holding of capital assets. Consequently there is no passive gain.

- **Making money from money is not acceptable in Islam**

Making money from money is not acceptable in Islam, where money is only a medium of exchange; a way of defining the value of a thing. It has no value in itself and therefore should not be allowed to give rise to earning more money simply by being put in a bank or being lent to someone else at a fixed interest rate. Nowadays money in itself has no intrinsic value because it is fiat money created by government decree, and it is the government who declares it to be legal tender. Orr and Clark (2009:16) assert that that which is to serve as money and as a medium of exchange must have an intrinsic value of its own; moreover, they state that it is of crucial importance for the maintenance of social stability. On the same issue Vadillo (1996:52-53) states that gold could serve as money since its value is intrinsic and furthermore its value does not depend on any nation or economy. In contrast, national currencies like the dollar are simply pieces of paper, the value being as strong or weak as the

country which stands behind the currency. Vadillo further asserts that the universal currency for over 2500 years was made up of small pieces of gold and silver in the form of coins, which were valuable in themselves, such as the early dinar and the dirham which contained 4,2 grams of gold and 3 grams of silver per coin respectively. Thus the initial form of money existed in the form of a full metal coin; as the economy advanced, paper money came into circulation, but was backed for the full 100 per cent by gold reserves. Today the position is somewhat different, for money in itself has no intrinsic value as it is no longer backed by gold. Its value, as enunciated by Vadillo (1996:66), is determined by a complex mechanism of relationships between political and economic institutions. Since money lacks intrinsic value at present, this is one of the main reasons that justifies reverting to gold and silver to serve as money. Hosein asserts that without doubt this would be the best long-term hedge against any economic and political meltdown (Hosein 1997:130-133).

- **Gharar (uncertainty, risk or speculation)**

Khan (2006:7) asserts that Gharar is also prohibited in Islam, and under this prohibition any transaction that is entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the countervalues intended to be exchanged as a result of their transactions. Samadani (2007:15) states that the literal meaning of Gharar in Arabic means to cheat, or uncertainty. In other words, it refers to behaviour that can be regarded as dishonest or any situation that is unclear or ambiguous. Khan (2006:70) further quotes Mujb Allah Nadwi who states that Gharar arises in transactions where it involves the following elements: uncertainty, ignorance, or gambling. Samadani (2007:15-25), however, categorises Gharar into the following types and briefly explains the concept as follows:

- ***Uncertainty towards the existence of the subject matter.*** This refers to a situation or contract in which the subject matter is non-existent. Such trade is prohibited and consequently void from inception, e.g. where a seller sells an unborn calf or a crop that has not yet been sowed. In terms of modern legal systems Gharar can be regarded as unfair business conduct.
- ***Uncertainty towards the possession/ownership of the subject matter.*** This refers to a situation where the seller disposes of goods without having any legal title to it. The contract is rendered automatically invalid, e.g. a seller sells a cow or something else that is not his possession or in his ownership.
- ***Uncertainty in respect of the price.*** This happens when the parties decide to enter into a transaction in which the exact price of the subject matter is not stipulated. Therefore neither the seller nor the buyer knows to how much money will be earned from or spent on these goods. In a wider context Gharar could also include cheating or deceitful conduct where one of the parties has the intention to deceive or mislead the other.
- ***Uncertainty towards the payment of the price.*** It is advised that the price should be paid immediately at the closing of the agreement so as to avoid any doubt or ambiguities. Moreover, a spot payment will ensure that the seller gets his due remuneration and that the buyer has a serious intention to buy. It is for this reason that derivatives such as put options are invalid due to the speculative nature of the transaction.
- ***Ignorance (Jihalat)***  
This is one of the ways in which Gharar is expressed where it involves a party entering into a transaction in which there is a complete lack of knowledge and awareness of either the outcome, or the material implications surrounding the said transaction or contract, for instance, engaging in some gambling activity.

In the main it must be noted that Gharar cannot be perceived as a specific element but rather as a whole set of elements depicting different behaviours. The idea in Islam is to facilitate trade and hence the rationale in banning Gharar is the promotion of good Islamic business conduct among all participants, to prevent exploitation and the undertaking of blind risks.

### **4.3 PROFIT AND LOSS SHARING (PLS) AND BANKING**

According to Venardos (2005:51) it is common practice for businesses to start off their business ventures with a loan. In the case of Muslim-owned businesses, loans according to the traditional banking system are not permissible since they involve the charging or paying of interest. Islamic banks allow prospective clients to borrow money whilst still adhering to Sharia law through what is known as a profit and loss sharing (PLS) scheme of financing. Profit and loss sharing (PLS) financing is a form of partnership whereby the partners share profits and losses on the basis of their capital share and effort. Unlike in the case of interest-based financing there is no guaranteed rate of return. Islam supports the view that Muslims do not act as creditors in any investment, but are actual partners in the business.

It is actually an equity-based system of financing and the justification for the PLS financiers' share in the profit rests on their effort and the risk that they carry. In other words, they deserve to be rewarded since this profit would not have been possible without their investment. Moreover, in the event that the investment makes a loss, then the financier's money would also be lost.

According to Ariff (1988) a number of different financial instruments have been innovated and developed by Islamic banks over the past few years and such instruments have been used as alternatives to the instruments and mechanisms prohibited under Islamic law. In this development four important principles seem

to have been taken into account, namely:

- There is no guaranteed rate of return on borrowed funds; and Muslims should not act as creditors in any investment but as actual borrowers.
- Risk taking when related to a commercial enterprise is a socially productive economic activity and consequently entitled to a reward.
- Loans are meant to finance socially productive economic activity.
- Financial risks rest solely with the lenders and not with the manager or agent.

From the Islamic perspective a person is not entitled to a reward or to earn money without taking a risk. The lender who advances money for the purpose of trade and production can contract to receive a share of the profit, for in so doing he becomes a partial owner of the capital of the enterprise and shares in the risk, that is, he receives a portion of the profit if the business does make a profit and of course he shares in the loss if the business makes a loss. This differs from the procedure followed in the traditional banking system, where a person who lends money to another without the risk of owning and operating capital goods, claims interest regardless of the profit or loss realised out of the enterprise. The creditor runs a risk but it is a risk of the solvency of the borrower and not of the success or failure of the enterprise. Much confusion between risk linked to trade and risk in lending of money seems to occur when money is treated as a commodity. It is often presumed that just as a merchant is able to sell his commodity for a higher price than his cost, in a likewise manner he can also sell his money for a higher price than its face value and could claim interest thereon. Usmani (2001:80) asserts that Islamic principles do not subscribe to this presumption for he maintains that money and commodities have different characteristics and should therefore be treated differently. The differences he outlines are as follows:

- Money has no intrinsic utility since it cannot directly fulfilment human needs.

- Commodities can be of different qualities while money has no quality except that it serves as a measure of value or medium of exchange.
- In commodities the transactions of sale and purchase are effected on an identified particular commodity; however, money cannot be pinpointed in a transaction of exchange, for if A has purchased a commodity from B by showing him a particular note, say a R100 note, he can still pay him with another note of the same denomination.

According to Usmani (2001), based on these differences, Islamic Sharia has treated money differently from commodities on the following two dimensions:

- Firstly, money insofar it pertains to the same denomination or currency is not held to be the subject matter of trade like commodities are; for instance, Rands as currency cannot be bought and sold at a price like a commodity. Its use is restricted to its basic purpose, that is to act as a medium of exchange and a measure of value.
- Secondly, under exceptional circumstances where money has to be exchanged for money or in the event that it is borrowed, the payment on both sides must be equal so that money is not used for the purpose it was not meant for, that is, trade in money itself.

So as to drive this point home, Usmani (2001:86) highlights the comment of a member of the Economic Crisis Committee during the Great Depression in the 1930s where a certain Mr Dennis Mundy, a committee member, made the following recommendation, so as to ensure that money performs its function of operating as a means of exchange and distribution: that it would be desirable that it should cease to be traded as a commodity. In the same vein the pagan Arabs also used to argue with Prophet Muhammad (PBUH) that Riba transactions as practised were fully justified because the income that they earned through interest was very similar to the profit that they earned through sales. They

rationalised using the following words as mentioned in the Quran (2:275): “Sale is nothing but similar to trade.”

In response to their argument the Holy Quran could have mentioned the difference between interest and profit in a pure logical manner as to how profit in a sale transaction is justified whilst interest is not. It could have also elaborated on the evil consequences of Riba on the economy as such, but this line of argument seems to have been avoided intentionally and the brief and simple answer given in the Quran (2:275) was: “Allah has allowed the sale and has prohibited interest.”

This point of view now forms part of divine law in Islamic thought, as promulgated by Allah the Supreme and as such this law is unchangeable and immutable. No matter what scientific reasoning one may advance in justifying the permissibility of Riba transactions and the taking of interest as a reward for the taking of risk, it is still deemed to be unlawful. The underlying rationale is that there is no room for dispute on matters that God Almighty has made unlawful and no degree of rationality advanced will make it lawful.

Another contentious issue which keeps on surfacing and which needs clarification is that of the permissibility of rent on property compared to the impermissibility of rent (interest ) that is levied on money that is lent out. The argument is that property loses value and therefore rent is just a reimbursement for lost value whilst money also loses purchasing power due to inflation and interest is therefore its compensation. In this regard the comment of Mr Amman Muhammad, the managing director of ABSA Islamic Banking (Mail & Guardian, 2010) is worth noting, where he states that Islamic banking is based upon “a real economy there are no notional transactions – everything is asset-based according to Islam, money is not a commodity in itself but a means of trade”. Dr Imran (2012) looks at renting or leasing of property from the Roman law context of *usufructus* in that it refers to the transferring of the use of the goods and not

ownership to another person for an agreed period at an agreed fee or compensation; however, with the following proviso:

- That the leased property be valuable, identified and quantified
- No consumable goods can be leased

The corpus of the leased property remains in the ownership of the seller and it is only its usufruct (use of the commodity) which is transferred to the lessee. Harry Thurston Peck, in his *Harpers Dictionary of Classical Antiquities* (1898) refers to *usufructus* as a so-called “real right” which entails the value of using and taking the fruits of the property whether movable or immovable, but the use of which does not diminish its substance. The following can therefore be deduced from the foregoing:

- A leased property remains in the ownership of the seller.
- The lessee is only entitled to the fruits or the use of the property.
- That which cannot be used without consuming it cannot be leased, e.g. money.

The usufructuary (lessee) is given the use of the property whilst its ownership still vests in the hands of the lessor; accordingly, the lessee pays the lessor for the use and enjoyment of his property which is termed rent. Hence the argument that rent is just a reimbursement for lost value does not carry any weight. It follows from the above discussion that money, being a consumable item in itself, cannot be leased and therefore it would be incorrect to speak in terms of the renting of money. According to Iqbal and Mirakhor (2011:67) interest is the practice of charging a premium in excess of the principal amount of a loan. The justification for this is that since money loses its purchasing power due to inflation it necessitates a charge of interest is also invalid, for if interest were the compensation for inflation then the rate of interest would always have matched the rate of inflation; obviously this is not the case. The rate of interest is in fact

determined by the supply of and demand for money and not by the rate of inflation at the time of the contract. Therefore it is not correct to state that interest is a form of remuneration for money losing its purchasing power over time due to inflation (Usmani 2001:107). Inflation is a man-made problem and there seems to be no reason as to why what Muslims regard as a divine rule should be relaxed because of man-made problems. What is required is effective monitoring of inflation through the promulgation of sound macroeconomic policies. The view of interest being a predetermined fixed sum due to the owner of loan funds by the borrower, irrespective of the outcome of the business enterprise, thus remains intact.

At this juncture it is also appropriate to throw more light on the concept of Gharar for it might be seen as confusing that whilst financial risk is permissible in Islam, Gharar, which also has an element of risk, is forbidden. In legal and business terms Gharar means that someone enters into a commercial venture blindly, without sufficient knowledge; or else enters into an excessive risky transaction. The concept can be applied in a number of different circumstances. In general, risk as such, like hardship, is not desirable for its own sake. Hardship is endured only when the envisaged benefits outweigh associated hardship. In a likewise manner, risk becomes desirable only when it stimulates productive efforts and value-adding activities.

However this does not imply that any decision to take risk is prohibited in Islam. The practice of Mudarabah (see section 4.3.1 below) involves considerable risk; yet it is perfectly acceptable. Therefore there must be something more than uncertainty or risk that influences the desirability of a given transaction. According to Al-Suwailem (2000) Islam does not prohibit a contract just because it involves risk, but the objection arises when risk becomes a channel to make one party profit at the expense of the other, for it is then that it assumes the element of Gharar. The author continues to say that in Arabic the notion of risk implies delusion or deception. Kamali (1999, cited in Cattelan, 2009) holds a view of Gharar which

seems to concur with Al-Suwailem's concept of Gharar literally meaning *fraud* (Arabic: al Khida): "Gharar in transactions has often been used in the sense of risk, uncertainty and hazard [...] gharar ...includes both ignorance over material attributes of the subject matter and also uncertainty over its availability and existence." Cattelan himself seems to favour the version that the term Gharar is usually translated as "risk", but it could probably be better understood as related to a "danger of loss" in accordance with its semantic root GH-R-R, "to deceive"; "to mislead". Gharar then means risk, hazard, jeopardy, danger, or peril. Ghoul (2011:294) in his article on Islam and entrepreneurship in the *World Encyclopedia of Entrepreneurship* states that gambling or Gharar, which means "uncertainty" or "deceit" in Arabic, is a speculative activity that is forbidden since it involves the taking of risks which are intentional, avoidable and significant. Abdullah and Chee (2010:54) cite an appropriate example of Gharar, for instance the seller of a house who intentionally conceals a termite problem and thereby exposes the buyer to an unfair risk or Gharar.

It appears that the positions of scholars are also somewhat divergent in their interpretation of the concept of Gharar but certainly that which seems to emerge and which is common ground among all writers is that the contract in itself must be unambiguous, the price has to be firmly established and both the product and its attributes and the object of the sale must be known to the parties. As a matter of course there should also be full disclosure, there being no concealment of product defects or else the contract would be categorised as not being Sharia compliant and thus invalid. It is also interesting to note that South African law also sets aside contracts on the following grounds which are akin to Gharar, namely misrepresentation, duress, undue influence and commercial bribery (Hutchison *et al.* (2011:145). In South Africa the Consumer Protection Act 68 of 2008 serves to protect the interest of the consumer; in its preamble it mentions that the purpose for its enactment is the following:

- to promote and protect the economic interest of the consumers

- to improve and access to and the quality of information that is necessary so that consumers are able to make improved choices according to their individual wishes and need
- to protect consumers from hazards to their well-being and safety
- to develop effective means of redress for consumers
- to promote and provide for consumer education including education concerning the social and economic affairs of consumer choices
- to facilitate the freedom of consumers to associate and form groups to advocate and promote their common interests
- to promote consumer participation in decision making processes concerning the market place and the interests of the consumers

It is quite evident that the vision of the Consumer Protection Act 2008 seems very much akin to the concept of Gharar for both seem to safeguard the individual from being prejudiced as a result of deception, cheating and fraud on the part of sellers. This is corroborated by the enactment of section 40 of the Act which prohibits various forms of unconscionable conduct on the part of suppliers or their agents. They are not to use physical force against a consumer, nor coercion, undue influence, pressure, duress or harassment, unfair tactics or any other similar conduct in connection with, among other things, the negotiation, conclusion, execution or enforcement of an agreement to supply goods or services to a consumer .In addition it is unconscionable for a supplier knowingly to take advantage of the fact that a consumer was substantially unable to protect his or her own interest due to physical or mental disability, illiteracy, ignorance or inability to understand the language of an agreement or any other similar factor. Section 41 likewise has provisions prohibiting misrepresentation and non-disclosure of material fact to consumers. From the foregoing it is clear that Islam is not against risk taking per se; in fact, for the deal being Sharia compliant there has to be an element of risk, but such risk cannot be improperly imposed onto another so that the person suffers prejudice. In other words, the deal cannot be tainted by deception or misrepresentation, or found lacking in respect of full

disclosure of material elements. Gharar does not have a single definition for it is a very broad concept and viewpoints of writers also differ.

Venardos (2005:75) points out there are currently two major and several minor types of profit and loss sharing partnership contracts which are used by Islamic banking institutions for project finance and investment purposes. Some transactions may require the use of a combination of such contracts. In the following section a brief outline is provided of different contract types as highlighted by Venardos.

#### **4.3.1 Al-Mudarabah (trustee profit sharing)**

A bank conducting business by adhering to the principle of Al-Mudarabah could finance acceptable projects. In this case the bank acts as a “provider of capital” and will sanction 100% financing towards the relevant project. The initiator of the project is the entrepreneur whose responsibility will be to manage the project. The bank undertakes not to interfere in the management of the project, although it retains the right to undertake follow-up and supervision tasks. Both parties agree through negotiation on the ratio of the distribution of the profits generated from the investment. In the event of the project making a loss the bank bears part of the loss. The ratio of distribution of profits between the bank and the entrepreneur may vary from borrower to borrower; for example, if the bank lends money to two borrowers, namely to Pick n Pay and a corner shop, then the profit sharing ratios will differ in respect of the two borrowers. There are several factors that contribute to this variability, and questions influencing the decision are the following:

- Is the bank lending money to the prospective borrowers on sympathetic grounds?
- Is the bank lending money to the borrower so that the principal may be served?

- Is the bank advancing money to the prospective borrowers to share in the profits of the borrower?

With regard to the first two cases the bank is not entitled to claim any additional amount above the principal loan amount, since the bank is lending the money to the prospective borrower on compassionate grounds; for example, in the case of a corner shop that approaches the bank for a loan for purchasing more stock to donate to the community it serves which has been hit by a severe drought. The bank could possibly lend such a corner shop money on the basis of an interest-free loan on a zero profit-sharing ratio recovering only its principal sum advanced, since the issuing of the loan was based on humanitarian grounds. Also in the second instance the sole motive for the bank to lend money was to secure the principal sum advanced and not to earn an income and therefore in this instance it will be granting an interest-free loan as well.

Concerning the third instance where the bank wishes to enter into the transaction as a partner of the borrower and share the profits with the borrower, the motive in this case is somewhat different. The only way in which the bank could possibly achieve its objective would be by entering into a joint venture with the borrower and both will share in the outcome of the business venture at some agreed ratio. In the event of a loss the bank will also share in the loss.

In a case where the Islamic bank were to grant an equal loan to say Pick n- Pay and a corner shop, but not on humanitarian grounds, the profit-sharing ratio would be determined by a number of factors which need not be the same in respect of both enterprises. Some of the factors that could play a pivotal role are the following:

- The reasons for borrowing money and the envisaged duration – whether it is for the short term, medium term or long term, or simply to

manage the cash flow requirements, expand current activities or to establish new enterprises

- The size of the enterprise and the period of existence
- The enterprise's financial statements
- Whether the loan is required to finance new projects or existing projects
- The expected yield of the project
- Personal knowledge and capabilities of the entrepreneur in the area in which he intends injecting the money
- Trust in, and honesty and integrity of the entrepreneur
- Whether the borrower has provided any collateral (if he has, consideration of the size of the loan requested against the value of collateral)
- Risk of default on the part of the borrower by considering his credit rating and a history of his past honouring of debts
- Whether the borrower has a good understanding of the market within which he operates
- Whether the bank will be involved in exercising supervision and control over the activities of the borrower

An in-depth scrutiny of the above factors will have to be undertaken before an Islamic bank will grant a loan and determine the profit-sharing ratio, the reason being that the Islamic bank would become a partner with the borrower and share in the profit and loss. Each case will have to be judged on its own merits and the profit-sharing ratio has to be an agreed negotiated ratio between the parties.

#### **4.3.2 Al-Musharakah (joint venture profit sharing)**

A bank could also undertake to finance acceptable projects according to the principle of Al-Musharakah. The bank, in this case together with the initiator or initiators of the relevant project, will provide the equity financing for the project in

agreed proportions. All parties, including the bank, have the right to participate in the management of the project; however, all parties have the right to waive such a right. The parties agree through negotiation as regards the distribution of profits which may be generated from the project. This ratio, however, need not coincide with the ratio of participation in the financing of the project, but in the event of a loss in the project all parties bear the loss in proportion to their share in financing. Siddiqui (2007) stresses the point that the ideal mode of financing under the Islamic banking system is “financing by way of the profit and loss sharing” (PLS basis) He further emphasises the point that Islamic banks does not normally lend money except for interest-free loans which are termed as Qard-al-Hasnah (benevolent loans) which are to be used for the benefit of individuals or society at large. Authors such as Siddiqui (2007), Venardos (2005:77), Kazarian (1991:73) and At Tijaarah (2007) also identify other modes of financing; however, contrary to the PLS contracts these modes of financing are based on a predetermined and fixed rate of return. Some of the more important ones will be briefly discussed below as other modes of financing contracts based on a predetermined and fixed rate of return.

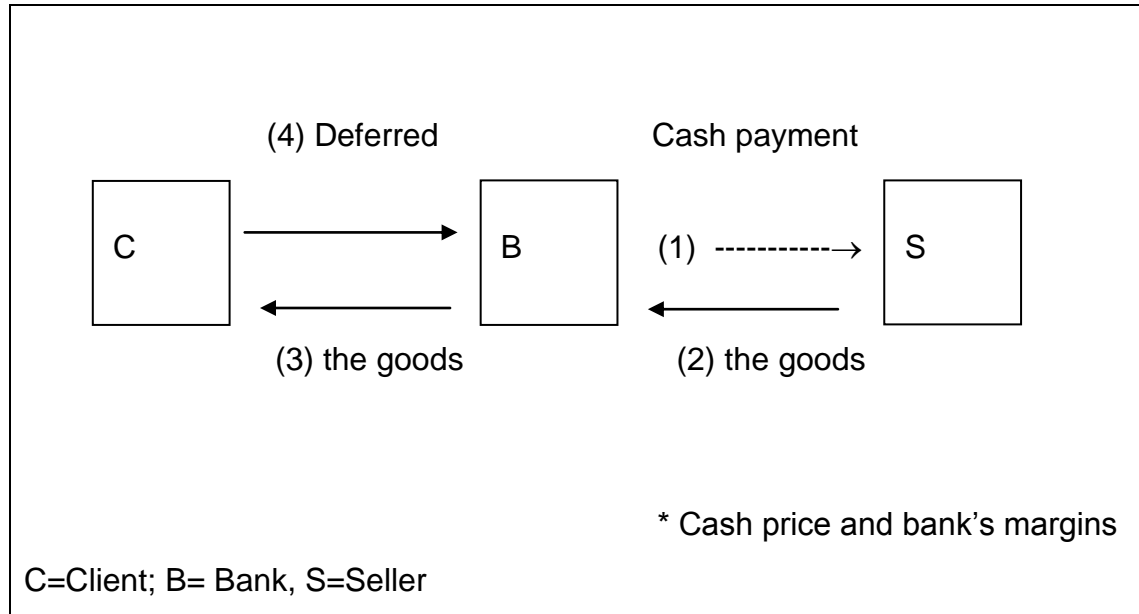
- **Murabaha (Cost plus mark-up)**

Chapra (1983:169) states that in respect to the Murabaha sale, the seller supplies the goods to the buyer at a specified profit margin that has been mutually agreed between them in which the terms of payment could either be cash or by any other means, immediate or deferred. If applied to the banking context then the bank purchases the goods desired by its client who is seeking financing for a purchase which the bank then sells to its client at an agreed price which yields a specified profit margin to the bank. The repayment, however, is settled by the client within an agreed time frame in the form of a lump sum or in instalments. Chapra also asserts that the risk for the transaction is borne by the bank (financier) until the goods are passed over to the client. This form of financing is widely used by the Islamic Development Bank for its foreign trade

financing operations and also by almost all Islamic banks established so far.

This mode of financing is illustrated in Figure 4.1 below:

**Figure 4.1 Murabaha mode of financing**



Source: Tahir (2003): Future of Islamic Banking

In this case a client (C) may approach the bank (B) to provide financing for working capital requirements so as to purchase stocks, inventories, spares and replacements, or semi-finished goods and raw materials. The client (C) needs the funds to meet the seller's (S) demand for payment. The bank (B) first purchases the desired items, or else it appoints the customer as its agent to purchase the goods on its behalf. The bank settles the purchase price from its own funds to the seller(s). The bank (B) then sells the goods to the client (C) at an agreed price comprising its own purchase price and a profit margin. The client is allowed to settle this selling price on a deferred term of thirty, sixty, ninety days or any other period agreed upon; on the due date the client pays the bank the agreed selling price.

- **Al-Ijara (Financing the use of services of an asset through leasing)**

The notion of Al-Ijara refers to a leasing contract, which is similar to any leasing activity provided in the traditional financial system. The bank leases an asset to its client for a fixed period; the rental amount being agreed in advance. This form of financing is based upon the financial status and cash flow projections of the client relating to the utilisation of the goods to be acquired. The client assumes all risks of loss relating to the goods after he receives those in his possession under the Ijara contract.

- **Ijara wa Iqtina (Lease purchase financing)**

This type of contract is termed a lease purchase contract when the transferring of the ownership of the asset to the client completes a leasing contract.

- **Al-Qard-al-Hasan (Benevolent loans)**

These are loans which are repaid at the end of an agreed period without any interest charged on the loan amount, or share in the profit or loss of the business. It is therefore a kind of loan free of obligation that is given to the needy people for a fixed period without requiring the payment of interest or a profit sharing motive. The receiver is only required to pay back the original amount of the loan. This form of loan strictly follows Islamic law principles.

- **Salam**

This type of contract entails paying now for a commodity to be delivered at some later, preagreed date. Under this mechanism a bank contracts to purchase a product to be delivered at a future date but pays the price in advance. This finance structure is useful in the agricultural sector; e.g.

payment is made in advance for a farmer's crop which is thereafter sold on the market at a profit. It may appear to go against the Islamic rule that it is unlawful to sell a non-existent product; however, Khan (2006:9) states that this form of transaction is an exception to the general rule and that one needs to comply with certain strict requirements of the Sharia before it is executed. Salam resembles a future contract, which is a derivative contract found also in financial and commodity markets.

- **Istisna**

This entails paying now for delivering at some later preagreed date for a commodity that has yet to come into existence; for example, money is advanced to a manufacturer of built-in cupboards so that he is enabled to buy the raw materials to make the built-in units where delivery takes place at a later, preagreed date.

It is vital to note that there are many factors that will impinge on the execution of such transactions or on the nature of the commodity and naturally these factors will affect its validity in terms of Sharia (Islamic religious law). The above descriptions are basically intended to provide a broad conceptual overview of the different modes of financing. A complete discussion of the technical details and finer points of the above transactions is beyond the scope of this research.

In summary it is clear that the scope of the application of the above Islamic finance techniques has a wide bearing on the world of finance today (At Tijaarah 2007). Both conventional and Islamic financial institutions are commercial enterprises taking risks and seeking returns on their investments and efforts. Just like conventional banks Islamic banks offer products such as savings and current or cheque accounts as well as fixed deposits; however, these products are structured to comply with Sharia principles. The following products are generally offered by Islamic banks:

- Murabaha : House finance, fixed asset finance
- Musharaka : Venture capital, private equity
- Ijara : Asset finance
- Salam : Agricultural finance, hedging
- Istisna : Asset finance, trade finance
- Mudarabah : Venture capital investment funds

#### **4.4 THE PROFIT AND LOSS SHARING SYSTEM: INSTITUTIONAL AND OPERATIONAL ISSUES**

Islamic Sharia law provides rules that encompass the allocation of resources, management, production, consumption, capital market activity and the distribution of income and wealth. They also define in broader terms a general framework for designing monetary and banking systems. The pioneers of Islamic economic thought developed their ideas of conducting business based on Islamic laws or as they are better known, Islamic economic principles. The concepts are based on the use of productive (real) investment rather than of monetary investment that attracts interest (Joosub 2005).

Tahir (2003) contends that Islamic banking started in earnest in the 1970s resulting from the personal initiative of concerned Muslims who wanted to address the problem of Riba. Under these pioneers were committed and resourceful individuals, professional bankers, Islamic economists and religious scholars. There was no initial working model to act upon except the thought that interest-based banking might be replaced by banking on the basis of profit and loss sharing. This initiative took place when the financial system at large as well as the regulatory environment was Riba based. However, Ariff (2007) considers Islamic banking as a new phenomenon that has taken observers by surprise. He contends that the banking systems in Iran and Pakistan have been completely Islamised.

The correct position is that worldwide there are approximately 265 Islamic banks and other financial institutions that are operating in some 40 countries with total assets that amount to \$262 billion (Islamic Finance Forum, 2005). According to Ilias (2010) the monetary authorities of the countries where the Islamic banks are operating in coexistence with the conventional finance intermediaries are willing and eager to cooperate with Islamic banks. The advantages for Islamic financial intermediation is seen in the fact that increased competition will result in an expansion of the banking public (both in terms of mobilisation and allocation of financial resources) and socially desirable services, which Islamic banks provide. Since Islamic banks started to operate in economies based upon interest, financing the development of what might be called the microeconomic foundations of Islamic banking institutional structures began to take shape within the financial sectors of these economies. Misgivings are often expressed about the viability of Islamic banking but a thoughtful evaluation of Islamic banking would lead to the conclusion that these apprehensions are not well founded. In the following section the framework in which an Islamic bank is established will be reviewed and the sources of capital and bank earnings of an Islamic bank will be outlined.

#### **4.4.1 Establishment of an Islamic bank**

According to Kazarian (1991:62) the objectives of Islamic banking are multifaceted and vary among Muslim scholars and professionals. In addition to providing financial facilities the task assigned to Islamic banking is to realise the Islamic concept of socioeconomic development. It is imperative that Islamic banks participate actively in the process of economic and social development of the Islamic countries within the framework of Islamic rules and norms. The main goals of the Islamic socioeconomic development approaches are to increase the economic welfare of Muslims and to simultaneously attain social justice and an equitable distribution of income and wealth. Al-Qardawi (2004:185) also maintains that Islam has made it obligatory for Muslims to prosper in the material

life and avoid unnecessary expenditure. It therefore provides safeguards against wastage of wealth on liquor, luxury goods, and vain games and similar pastimes which are seen as ways to fulfil evil desires of the mind and body.

Iqbal (2001:187) asserts that all transactions in an Islamic market have to be governed by the norms of Islamic ethics as enunciated by the Sharia, and all funds are to be channelled exclusively into desirable projects. Muslehuddin (1988:107) is of the opinion that there exists no statutory definition of a bank that is all-encompassing and hence he states that a bank could be a financial institution operated by an individual as sole proprietor or it could be a partnership, or a corporation, or any other type of association. Therefore, in line with the Islamic principle stating that what is not forbidden is permissible, an Islamic bank therefore may be a company, an association or a concern owned by an individual. Iqbal (2001:2) states that as a theoretical construct an Islamic bank, like any other bank, is a company whose main business is to mobilise funds from savers and to supply these funds to businesses or entrepreneurs. A number of individuals normally supply the share capital for a bank so that enterprises may be financed and services rendered for earning profit on the basis of Musharaka and Mudarabah, as discussed in the previous sections.

On the matter of resource mobilisation it is maintained that the Islamic bank uses either the contract of Mudarabah or of Wakalah (a contract of agency; in this type of contract one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee). Under the first type of contract the net income of the bank is shared between shareholders and investment deposit holders according to a predetermined profit sharing formula. The investment deposits can be either general investment deposits that enter into a pool of investment funds or some specific investment accounts in which deposits are made for investments in socially desirable objects. In the case of a Wakalah contract clients deposit funds with the bank where the bank serves as their investment manager. The bank charges a predetermined fee for its managerial services. The

profit or loss is passed on to the fund providers after deduction of a fee.

El Gamal (2006:138) stresses the point that the providers of funds are viewed as principals or silent partners extending their funds to the Islamic bank who is viewed as an entrepreneur or investment agent. The Islamic bank would thus invest the funds on the principal's behalf in exchange for a share of any profits. If the investments are not profitable the bank or agent would lose only its effort, and the principals would bear all the financial losses. In turn the bank may invest directly or act as a principal in a second investment agency contract (silent partnership).

#### **4.4.2 Sources of additional capital**

Important issues concerning the sources of additional capital or supply of funds to Islamic banks involve a review of the types of accounts these institutions offer. Islamic banks invite deposits in current or cheque, savings and investment accounts. The ways in which deposit monies can be attracted are discussed below as set out by ABN AMRO Islamic Bank (2007; Sharia Banking Net 2007).

- **Current account**

In the case of a current or cheque account, customers are required to give to the bank their explicit approval to allow the bank to utilise their funds in other bank activities without receiving any return. Both sources cited above stipulate that Sharia-compliant current accounts do not attract or charge any interest. There is no overdraft facility available but if an overdraft is incurred, an administration fee is charged where such fee imposed will cover the bank's actual expenditure incurred in processing the application and maintaining the accounts. In such a case the administrative fee is not regarded as a source of income for the banks but it is regarded solely as a means of maintaining and managing the interest-

free loans. Such an administrative fee also will be much lower than the interest charged by the commercial bank where such interest represents the price that a client has to pay for borrowing funds. Interest serves as a major source of income for the traditional banks. The current account is operated on the basis of “Qard” where the funds from depositors are treated as a loan to the bank and no profit of any kind is payable to the depositors but the principal sum is guaranteed and payable to the client on demand.

- **Savings account**

*No notice account*

Savings accounts are usually run on the principle known as Mudarabah where a profit-sharing agreement is drawn up between the depositor and the bank. A combination of no notice, term deposits and treasury accounts are usually available. With no notice accounts there are no limits to the amount that one can withdraw in any month (as long as sufficient funds are available in one’s account) and no withdrawal penalties are attached.

*Term deposits*

For term deposits there is usually a minimum deposit required. Rather than earning interest on deposits depositors will rely on the bank to use their funds to trade in Sharia-compliant investments; the bank then shares the profit with such depositors according to predefined ratios and weighting. In some cases the bank may also invest its funds in the pool and become a partner itself. In case of a loss as per the Islamic financing principle of Mudarabah, the loss will be borne by the Raab-ul-maal (depositors) whilst the Mudarib (bank) will get zero for its effort which in effect will constitute a loss to the bank.

Table 4.1 below briefly explains the profit-sharing mechanism.

**Table 4.1: Profit-sharing mechanism**

<b>CATEGORY</b>	<b>DEPOSIT (Rs)*</b>	<b>WEIGHTING</b>
Savings	3 000	0,1
1 month	1 000	0,3
3 months	3 000	0,5
6 months	6 000	0,6
1 year	7 000	0,7
<b>TOTAL</b>	<b>20 000</b> <i>*Pakistani rupees</i>	

Source: ABN AMRO Bank Pakistan Ltd (2007)

According to the ABN AMRO Group (2009) ABN AMRO Bank NV is a Dutch bank which is currently owned by RFS Holdings BV, a consortium of the Royal Bank of Scotland Group, the Government of the Netherlands and the Banco Santander. The bank was created as a result of the 1990-91 merger between the Amsterdam-Rotterdam Bank (Amro Bank) and Algemene Bank Nederland (ABN). In recent years ABN AMRO has weathered many changes from which it emerged as a strong player in the banking world. At the end of the third quarter of 2009 the total assets of ABN AMRO amounted to EUR 203 billion. With an international presence in 16 countries and territories ABN AMRO employs about 22 300 people, of which 3 000 are employed outside the Netherlands. The Dutch state-owned business serves over 4 million retail clients and more than 370 000 business clients. The bank offers a variety of products and services via a diversity of channels like banking outlets, business centres, call centres and internet. ABN AMRO also has an Islamic window providing Islamic financial products based on Sharia principles in Pakistan.

Clients making use of this Islamic bank division deposit funds that collectively go into a pool of funds with ABN AMRO Islamic Bank as the fund manager (Mudarib), which invests these funds into Sharia-compliant assets or investments which are typically both listed and unlisted share investments. The relationship between ABN AMRO Bank and the depositors is that of Mudarib and Raab-ul-maal. This will be illustrated by way of an example. Let us assume there are five categories of depositors that hold the following account types:

- i) Savings account
- ii) 1 month term deposit
- iii) 3 month term deposit
- iv) 6-month term deposit
- v) 1 year term deposit

The profit that is earned by investing the funds in Islamic assets or investments is distributed between the bank and the depositors according to weightings that are announced at the start of the month as an illustration of the profit distribution ratio between ABN AMRO Islamic Bank and the depositors. Let us further assume that the ratio is equal (i.e. 50/50, as shown in Table 4.2 below) and that the earned profit is Rs 4 000 for that particular month. The net profit that will be distributed is shown in Table 4:2.

**Table 4.2: Profit distribution between ABN AMRO Islamic Bank and depositors**

ABN AMRO BANKING	Rs 2 000
POOL OF DEPOSITORS	Rs 2 000

Source: ABN AMRO Bank Ltd. (2007)

Table 4.2 shows that ABN AMRO Islamic Bank as fund manager gets its share of the distributable profit. The profit of Rs 2 000 will be distributed among the various categories of depositors on the assigned weightage as indicated in Table 4.3.

**Table 4.3: Profit distribution among the various categories of depositors**

<b>CATEGORY</b>	<b>DEPOSIT (in Rs)*</b>	<b>WEIGHTING</b>	<b>PROFIT</b>	<b>RATE</b>
Savings	3 000	0,1	57	1,89%
1 month	1 000	0,3	57	5,66%
3 month	3 000	0,5	283	9,43%
6 month	6 000	0,6	679	11,32%
1 year	7 000	0,7	924	13,21%
<b>Total</b>	<b>20 000</b> <i>*Pakistani rupees</i>		<b>2 000</b>	

Source: ABN AMRO Bank (Pakistan) Ltd. (2007)

- **Investment account / term deposit account**

In this account the principal difference between Islamic banking and the conventional banking system emerges clearly. The public is encouraged to deposit funds in the investment account or term deposit account on the basis of a profit-sharing ratio for a specific minimum period. e.g. for 3, 5 or 10 years. This type of account is a suitable solution for investors who are looking for high returns on their reserves but these still have to be based on Islamic principles ensuring the depositors' peace of mind. Whether the investor is an individual account holder or a business entity seeking to capitalise opportunities,

the term deposit account offers one convenient and secure financial solution under a somewhat hybrid arrangement of Musharakah and Mudarabah Islamic modes of financing. The deposits are allocated to a specific pool of funds that are invested in Islamic assets. These are governed by predefined weightings that are based on the profit and loss sharing (PLS) mechanism in adherence to Sharia principles. Thus guided by the expertise of renowned Sharia scholars, the term deposit account provides investors with interest-free returns on their investments.

#### **4.4.3 Main sources of banks' earnings**

Since Islamic banks cannot earn interest by lending money they therefore have to undertake investment to earn a profit, not only for the bank itself but also for the depositors in the investment account. Some of the ways in which Islamic banks earn their profit are briefly outlined by Finance in Islam (2005), Siddiqui (1986:46), Ahmad, Iqbal and Khan (1983:262), and Iqbal (2001:3).

- **Chargeable bank services**

Chargeable bank services are services which are performed for a fee, commission or fixed charge, and include the transfer of funds, safe-guarding of jewellery and other valuables, acting on behalf of customers to purchase or deliver goods, offering of advice and consulting services. Islamic banks are justified in charging fees for these services because the fee is paid for a service that involves a real execution of effort or work on the part of the bank.

- **Share investment**

Islamic banks may provide finance options to new business concerns by

subscribing to a part of the share capital of such concerns. They may also underwrite the share issue of a concern provided it does not involve charging a fixed rate of interest; for example, they can take up a part of the equity at the very inception of a project at a negotiated price which can be lower than the face value of the share.

- **Investment on development projects**

Islamic banks also invest part of their capital in their own projects or in other development projects undertaken either in partnership with the government or with other financial institutions. These projects are usually of a long-term nature; however, the main advantage of these types of investment is the satisfaction of some social project that might be supported.

- **Investments on a profit-sharing basis**

This type of investment is the most important form of the profitable use of funds by Islamic banks. In this case the bank may enter into a contract with the entrepreneur as a partner to finance part of or the whole project on an agreed profit-sharing basis for a specific period. The usual practice is that the party managing the business venture will receive a greater share of the profit.

- **Other strategies**

Whilst it is generally recognised that the profit and loss sharing system is the main alternative to charging interest in an Islamic economic system, resort could be taken to other strategies.

- **Bai Muajjal / Murabaha (cost plus trade financing)**  
In the case of Bai Muajjal or Murabaha the bank arranges for the purchase of goods needed by the client and sells them to him on the basis of cost plus an agreed profit margin (mark-up), which can be paid back in instalments over a specified time period.
- **Ijara (Lease or hire)**  
In the case of Ijara the bank acquires equipment or fixed property and rents them to the user at a fixed charge.
- **Ijara wa Iqtina (Hire purchase)**  
In the case of Ijara wa Iqtina the bank finances the purchase of equipment and allows the client to use it on the basis of a contractual agreement under which the former receives in addition to payment of the cost of the equipment a share in the net rental value of the item.
- **Bai Salam**  
The strategy of Bai Salam entails that the bank enters into an agreement with a farmer for the advance purchase of agricultural produce. The bank makes the payment of the agreed amount at the time of entering into the agreement.

#### **4.4.4 Religious Supervisory Board of Pakistan / Sharia Advisory Board**

According to ABN AMRO Bank Ltd (2007) the Religious Supervisory Board of Pakistan is made up of Sharia advisors and dedicated financial advisors and religious scholars across the globe who ensure that all transactions carried out by ABN AMRO Islamic Bank adhere to Islamic banking principles. They establish rules for specific transactions and financial products and thereafter they monitor the bank's activities to make sure that they meet the rules agreed upon. If they are in doubt on any matter they then refer it to the global

Sharia Advisory Board that consists of eminent scholars who advise accordingly and also oversee all banking transactions and business dealings all over the world.

#### **4.4 ISLAMIC BANKING MOVEMENT**

Shahnawaz (2007:17) states that the struggle of humankind to liberate itself from the depredation of interest is as old as history itself and even predates the minting of money. Hamurabi, who ruled Babylonia from 2123 to 2081 BCE, has left for posterity the oldest book in the world, containing his code, which not only prescribes maximum rates of interest but also suggests the method of profit and loss sharing as opposed to Riba or interest. Shahnawaz further contends that most great men in history have opposed the notion of interest; from philosophers such as Aristotle to poets like Dante. Many ideas that could prove beneficial have been advanced, beginning with the idea of profit and loss sharing as set out in Hamurabi's code. The Jews, Christians and Muslims in turn adopted this idea. It is further asserted that the first interest-free bank by the name of Agibi Bank was started by the Jews in Babylonia in 700 BCE. The basis adopted was mortgaging some productive asset like a house, a piece of land, a horse or a slave which the borrower parted with and that the bank then hired out in exchange for a loan without interest.

In recent years Islamic banking and finance options have grown considerably in importance. This reflects the growing awareness and reassertion of traditional Islamic principles and the desire among many Muslim business persons to utilise revenues generated from their business in accordance with Islamic principles, as opposed to the strong influence of European mutual banking institutions and cooperatives. This influence applied equally to the Islamic banking experiments in Pakistan in the early 1950s as well as to the Malaysian Tabung Haji in the 1960s, which eventually gave rise to the fast

growing Malaysian Islamic banking sector. Dr Ahmed al-Najjar, in Mit Ghamr, Egypt, appears to have been equally influenced by the social and economic thought of the Muslim brotherhood in Egypt and the mutual banking institutions that he witnessed in West Germany during his years of study there (El-Gamal 2006:163).

According to Ahmad (1984:18) the earliest experiments in Islamic banking took place in most cases on individual initiative with government playing a more or less passive role. In fact, the movement towards the introduction of Islamic banking practices began on such a small scale that it went almost unnoticed. Before the advent of modern banking in Egypt and the Mit Ghamr experiment, landlords assumed the role of financial institutions or money lenders in agricultural economies. They provided money to poor peasants at a high interest rate (Wilson, 1983:79). Hershlag (1980:58) states that money lending was concentrated in the hands of Jews in Iraq, and of the Christian Copts of Egypt; hence very little room for interest-free borrowing existed. The majority of Muslims who were peasants borrowed on their future crops to survive and since money lending was in the hands of the non-Muslim minority it was based on interest. In respect of financial assistance that could be provided by the state it was restricted only to the wealthy merchants. Wilson (1983) further states that the first European bank was established in Cairo in 1856 and thereafter many other Western banks whose financial operations were interest based began to flourish. As a result of the dominance of these banks there was little opportunity for the practice of Islamic finance although there were groups of devoted, pious Muslims who were against interest-based transactions and who were very keen on practising interest-free transactions. However, their spirit was dampened as they did not gain much support from the government at that time and coupled with that the government was also attracted to the Westernised style of banking operations. Hershlag (1980) points out that there existed a few simple savings institutions which operated on an interest-free basis but which were

undercover due to the government's hostility towards anything it perceived as Islamic fundamentalism. Venardos (2005:64) asserts that the first Islamic bank was established in Egypt in 1963; it was called the Mit Ghamr local savings bank. The bank operated on the basis of Sharia law and prospered because it was able to meet the savings and credit needs of its customer base. The success of the Mit Ghamr local savings bank proved that a bank operating according to Islamic principles could flourish. Ariff (2001) quotes Ready (1981) and Siddiqui (1988) that the Mit Ghamr experiment lasted until 1967 by which time there were nine such Islamic banks in the country. These banks neither charged nor paid interest. They invested directly in trade and industry or in partnerships with others and shared the profit with the depositors. Ariff (2001) briefly traces the evolution of Islamic banking; his exposition is followed in the next section.

- **Nasser Social Bank**

The Nasser Social Bank was established in Egypt in 1971. It was declared an interest-free commercial bank, although its charter made no reference to Islam or Sharia law.

- **Islamic Development Bank (IDB)**

The Organisation of Islamic Countries (OIC) established the Islamic Development Bank in 1974, but this was primarily an intergovernmental bank aimed at providing funds for development projects in member countries. The IDB provides fee-based financial services and profit sharing financial assistance to other member countries; its operations exclude the charging of paying of interest.

In the seventies many changes took place in the political climate of many Muslim countries so that there was no longer any strong need to establish

Islamic financial institutions under cover. Thus a number of Islamic banks both in letter and spirit came into existence in the Middle East, including the following:

- i) Dubai Islamic Bank (1975)
- ii) Faisal Islamic Bank of Sudan (1977)
- iii) Faisal Islamic Bank of Egypt (1977)
- iv) Bahrain Islamic Bank (1979)

The Asia Pacific region was not oblivious to the winds of change affecting the Middle East. The following Islamic banks were founded in this region:

- **The Philippine Amanah Bank (PAB)**

The Philippine Amanah Bank (PAB) was established in 1973 by a presidential decree as a specialised institution without any reference to its Islamic character in the bank's charter. The establishment of the PAB was a response by the Philippines' government to the Muslim rebellion in the south and was designed to serve the special banking needs of the Muslim community. However, the PAB is not an Islamic bank in the strict sense of the word, since interest-based operations continue to coexist with the Islamic modes of financing. Efforts are underway to convert the PAB into a full-fledged Islamic bank.

- **Muslim Pilgrims Saving Corporation**

The first Islamic financial institution in Malaysia was the Muslim Pilgrims Saving Corporation, set up in 1963 to help people save for Hajj (pilgrimage to Mecca and Medina). In 1969 this body evolved into the Pilgrims Management and Fund Board or the Tabang Hajj, as it is now popularly known. The Tabang Hajj has been acting as a finance company which invested the

savings of would-be pilgrims in accordance with Islamic Sharia, but its role was limited as it was a non-banking financial institution. The success of the Tabang Hajj however provided the main impetus for establishing Bank Islam Malaysian Berhad (BIMB), which represents a full-fledged Islamic commercial bank in Malaysia.

Islamic finance institutions have also been established in countries where Muslims are a minority. There was a proliferation of interest-free savings and loan societies in India during the seventies. Other finance institutions in non-Muslim countries include the following:

- **Islamic Finance House**

Islamic Banking Systems (now called the Islamic Finance House) was established in Luxembourg in 1978 representing the first attempt at Islamic Banking in the Western world.

- **Islamic Bank International of Denmark (IBID)**

The Islamic Bank International of Denmark is the first full-fledged Islamic bank in Europe. Its capital stands in the vicinity of 30 million Danish kroner. Its main aim is to promote the business of Scandinavian companies having connections to the Islamic world; to serve other Islamic banks and to provide standard banking services. IBID claims to operate on a non-interest basis. The parent company, Islamic Banking Systems (IBS) has among its shareholders the Kuwait Finance House and the Abu Dhabi Ministry, consisting of prominent Muslim individuals (Islamic Port, 2004).

- **Islamic investment in Melbourne, Australia**

The Muslim Community Cooperative (Australia) Inc. (MCCA) is an Islamic finance organisation that was established in 1989 in Melbourne, Australia. It started off with a few dedicated members and with a modest capital of about \$A20 000. By the year 1997 it expanded its membership to over 1600 and its capital to over \$A8 000 000. It declared as its primary objective the provision of a comprehensive Islamic alternative for the financing needs of the Muslim community in Australia. A resolution to expand its activities into Sydney was then adopted by its board of directors. A steering committee consisting of five volunteer members from within the Sydney Muslim community was formed to follow up on implementation of the expansion resolution. The committee carried out its task with regular meetings in Sydney. A convenient site for the new branch was bought and relevant recommendations were passed to the MCCA main office in Melbourne. The new branch started its operations on 17 March 1997 (Kandil, 1997).

- **Al Baraka Bank in South Africa**

The Al Baraka Bank Ltd. in South Africa was established in terms of the Banks Act 23 of 1965 with its registered office in Durban; it was officially opened in March 1990.

Today there are many Islamic financial institutions operating all over the world. Table 4.4 below shows a representative list of some of the Islamic financial institutions operating in the different parts of the world.

**Table 4.4: List of Islamic financial institutions operating in different parts of the world**

MIDDLE EAST	SOUTH-EAST ASIA	INDIAN SUBCONTINENT	AFRICA	REST OF THE WORLD
<b>Bahrain</b>	<b>Brunei</b>	<b>Bangladesh</b>	<b>Algeria</b>	<b>Turkey</b>
ABC Islamic Bank (E.C.)	Islamic Bank Brunei	Islamic Bank Bangladesh	Banque Al-Baraka d'Algérie	Albaraka Turkish Finance House
Shamil Bank	Tabung Amanah Islam Brunei (TAIB) Islamic Development Bank of Brunei (IDBB).	Social & Investment Bank Limited	<b>Gambia</b>	<b>UK</b>
Noriba Bank	Islamic Bank Brunei	Islamic Finance and Investment Limited	Arab-Gambian Islamic Bank	Islamic Bank of Britain
Gulf Finance House	<b>Indonesia</b>	<b>India</b>	<b>Sudan</b>	Dallah Al Baraka
Albaraka Bank Bahrain	Bank Muamalat	Seyad Shariat Finance	Al Baraka Bank	<b>USA</b>
Citi Islamic Investment Bank E.C.	Takaful Islamic Insurance International	Al-Barr Finance House Limited (India)	Sudanese Islamic Bank	Amana Mutual Funds Trust
First Islamic Investment Bank	Bank Muamalat	Al-Ameen Finance & Investment Corporation	Omdurman National Bank Sudan	American Finance House, LARIBA Bank
Al-Amin Bank, Bahrain	<b>Malaysia</b>	Parsoli Corporation	Tadamon Islamic Bank Sudan	MSI Financial Services Corporation
<b>Iran</b>	Bank Islam Malaysia Berhad	Idafa Investments	<b>South Africa</b>	Manzil USA
Bank Melli Iran	Bank Muamalat Malaysia Berhad	<b>Pakistan</b>	Al Baraka Bank South Africa	
Bank Saderat Iran	MNI Takaful	Meezan Bank		
Bank Mellat	Syarikat Takaful Malaysia	Islamic Investment Bank Limited, Pakistan		
Bank Tejarat	Philippines	Al-Baraka Bank Pakistan		
Bank Sepah	Al-Amanah Islamic Bank	Grindlays Modaraba		
Bank Refah		Meezan Bank		
Export Development Bank of Iran				
Bank Sanaat o Maadan				
Bank Keshavarzi				
Bank Maskan				
Karafarin Bank				
Saman Bank				
Bank Eghtesad-e-Novin				
Bank Parsian				
<b>Jordan</b>				
Jordan Islamic Bank				
Islamic International Arab Bank				

<b>Kuwait</b>				
The International Investor				
Kuwait Finance House				
<b>Lebanon</b>				
Al-Baraka Bank Lebanon				
<b>Qatar</b>				
Qatar Islamic Bank				
Qatar International Islamic Bank				
Qatar Islamic Insurance Company				
<b>Saudi Arabia</b>				
Islamic Development Bank				
ICIEC				
Al Baraka Investment & Development Co.				
Al Rajhi Banking & Investment Corporation				
National Commercial Bank				
Bank Al-Jazeera				
<b>UAE</b>				
Dubai Islamic Bank				
Abu Dhabi Islamic Bank				
National Bank of Sharjah				
Emirates Islamic Bank				

Source: *IBF Net: Islamic Banks and Financial Institutions (2007)*

Today interest-based financial institutions in South Africa like Absa and First National Bank (FNB) have opened Islamic banking windows and commenced business, offering Islamic banking products since 2006. This is dealt with in greater detail in section 4.6.3 below.

## **4.6 REVIEW OF OPERATIONS OF ISLAMIC BANKS IN PRACTICE**

The notion of an Islamic banking enterprise is no longer confined to the realm of ideas. It has passed the stage of model building, has been given practical shape in a number of countries as depicted in Table 4.4 and is now attracting worldwide attention. In this section the financial operations of the Faisal Islamic Bank of Egypt, the Dubai Islamic Bank and the Albaraka Bank in South Africa will be reviewed.

### **4.6.1 The Faisal Islamic Bank of Egypt (FIBE)**

The Faisal Islamic Bank of Egypt is the first Egyptian Islamic commercial bank and ranks as one of the most important Egyptian banks. The bank officially started operations on 5 July 1979; however, the real start preceded that date by more than five years. The founders met and agreed to establish a bank in Egypt, operating in accordance with Islamic Sharia, that was to serve as a model for Islamic banks all over the world. His Royal Highness Prince Muhammad Al Faisal Al Saud, chairman of the board of directors, submitted the idea to a number of Egyptian officials and well-known personalities. The idea was widely welcomed on the popular as well as on the official level (Faisal Islamic Bank of Egypt, 2007).

The establishment of Islamic banks in a number of countries was facilitated by special enactments and suitable changes in banking legislation (Ahmad, 1985:8). In Egypt the Faisal Islamic Bank of Egypt was incorporated under Act 48 of 1997 which was endorsed by parliament in the aforementioned year and which licensed the incorporation of the bank as an economic and social institution taking the form of an Egyptian joint stock company operating in compliance with the principles of Islamic Sharia. The articles of incorporation were amended under Act 42 of 1981 and amended again for the second time under Act 97 of 1996 (Faisal Islamic Bank of Egypt, 2007).

According to Kazarian (1991:158) FIBE was founded by financiers who had strong political and social powers; 51 per cent of the initial capital of the bank was in the hands of a few owners from Egyptian origin and 49 per cent by Saudi Arabia and the United Arab Emirate countries.

- **Review of operations**

The bank commenced its operations in 1979 and has an impressive record of performance. According to Kazarian (1991:147) FIBE's authorised capital was \$500 million at the end of 1988. At that stage the bank had established ten branches and a further 13 were under construction. A second private Islamic bank, the International Islamic Bank for Investment and Development (IBID), was established in Egypt in 1980. This bank was incorporated as an investment and business bank. It started its operations in 1981, two years after the establishment of FIBE, the implication being that IBID did not have the initial monopoly advantage of FIBE. FIBE is considered to be a private commercial bank while IBID has the statutes of a private investment bank. However, the differences between both banks are negligible and in practice both types of banks are allowed to provide short-term and long-term finance as well as equity participation, and to engage in foreign currency activities.

Ahmad (1985:41) states that the total deposits of the bank stood at US\$24 million in November 1979 and had risen to US\$1 216,7 million in 1983. Table 4.5 below shows the share capital, deposits and investments of Faisal Islamic Bank of Egypt.

**Table 4.5: Share capital, deposits and investments of the Faisal Islamic Bank of Egypt (in millions of dollars)**

	<b>1979</b>	<b>1980</b>	<b>1981</b>	<b>1982</b>	<b>1983</b>
Paid-up capital	10,00	18,96	19,72	29,62	37,95
Deposits	23,62	140,13	469,20	792,59	1216,70
Investments	24,08	154,90	354,40	840,43	1303,47

Source: Ahmad (1985:49)

FIBE started operations by engaging to a large extent in short-term financing operations. The rate of return earned on money invested in assets as compared to Riba is justified since the assets earn a return due to their intrinsic utility and productivity whilst money in itself does not represent an asset, and thus the mere holding of money or its trading over time does not justify the earning of a return. It is in this respect, as asserted by Samadani (2007:11), that the rate of return differs from interest (Riba). However, the previous chapter dealt extensively with Riba and the difference between Riba and profit from an Islamic perspective. The rate of return that was paid to investment account holders was 10,7 per cent in 1979 and 12,03 per cent in 1981. It decreased to 10,1 per cent in 1983. The number of the bank's operations increased from 52 in 1979 to 2 535 in 1983. The amount involved increased from US\$9 million to US\$767 million over the same period. At present the Faisal Islamic Bank of Egypt (FIBE) as an Egyptian Islamic commercial bank conducts trade financing and investment activities through its head office in Cairo and has a network of 19 branches. The bank offers a number of services in the field of retail and corporate banking in addition to carrying out ventures of developmental and national interest. It also offers a number of Mudarabah operations to the central bank of Egypt. The bank's Islamic investment operations range from short-term, low-risk operations to medium-term and long-term operations of higher revenue. Its trade services include issuance and collection of banker's drafts, travellers cheques, postdated cheques and bills for institutions and online banking clients (Faisal Bank of Egypt, 2007).

According to the chairperson's report on FIBE for its financial year ended 31 December 2005 Mr Mohamed Al-Faisal Al-Saud highlighted the following salient aspects of the achievements of the bank. The most significant was the adoption of an investment concept that relied heavily on using non-typical modern risk-balanced Islamic financial instruments and the means of dealing within the framework of the capital market with the aim of developing and appreciating the value of the securities portfolio of the bank. Such a concept would focus on providing an innovative package of high quality banking services that keeps pace with the requirements of the banking business locally and internationally. A further achievement of the bank mentioned in the chairperson's report is the launching of a set of mainstream banking services that clients can access via international information networks by accessing the website of the bank. The bank has also put into operation automatic teller machines (ATMs) in preferential locations after linking them to the ATM network of other banks participating in the 123 services within the framework of the plan to extend units for accessing services rendered by the bank. Nationally the bank has opened five new branches in vital areas of the country.

From the viewpoint of the desire to diversify its activities and the fields of its investments the bank has signed an agreement with a number of large financial institutions and banks to establish two companies for joint insurance with an authorised capital amounting to one billion pounds for both companies. At the level of the bank's main performance indices the balance sheet total recorded a rise of 8,8 per cent to reach the equivalent of GBP16,4 billion. The net balances of investment increased by 7,1 per cent to reach GBP14,4 billion. As for the total investment in savings products this amounted to GBP14,8 million, recording a rate of increase of 8,3 %. Similarly the level of equity reached GBP 584,5 million compared to GBP548,3 million in 2004, and a net distributable profit amounting to GBP1000 million was achieved compared with BGP72,6 million in 2004. The Faisal Islamic Bank of Egypt reported earning results for the year 2006 of a net profit of GBP 118,5 million up from GBP 100 million for 2005. The bank's

turnover grew to GBP19,401 billion from GBP16,617 billion (FAIT, Cairo Stock Exchange 2007). The bank administers over half a million investment accounts and its total assets amount to more than US\$2 billion (Faisal Islamic Bank of Egypt, 2007).

#### **4.6.2 Dubai Islamic Bank (DIB)**

The Dubai Islamic Bank (DIB) was incorporated as a public joint stock company by an Amri decree issued on 29 Safar 1395 Hijri (corresponding to 12 March 1975) by His Highness the Ruler of Dubai to provide banking services based on Islamic principles (Al Islamic 2002). DIB's vision is to be the leading provider of innovative financial services in accordance with Islamic law. Its mission is to be the first Islamic bank worldwide that can truly translate Islamic economic principles into practice out of a firm belief in the need of humankind for an economic system based on the final revelation of the Quran. It intends achieving this by partnering with their clients in halal earnings, employing best practice, implementing the latest financial services technologies and placing trust in Allah (Dubai Islamic Bank, 2005).

- **Review of operations**

According to Ahmad (1985:42) the number of the bank's accounts initially rose from 890 in 1976 to 6 798 in 1981. The range of its investment avenues includes housing, industrial projects and commercial activities. DIB operates at present through five main business categories: retail banking, corporate banking, real estate, investment banking and proprietary trading investment. Debt capital markets are its major contributors to revenue, accounting for around 83 per cent of revenue in 2006 (Shuaa Capital Research Department, 2007). Over the years the bank has grown substantially and now ranks fifth among United Arab Emirates' banks in terms of assets and shareholders' equity. Its profitability has witnessed phenomenal growth over the past few

years from AED160 million in 2001 to AED1,56 billion in 2006, with a tenfold increase within a short span of five years (Arab Bankers Association of North America, 2007). The bank's recent financial results also confirm the strength of its balance sheet and profitability. The bank reported a net profit for the year ending 31 December 2005 of AED1 061 billion, an increase of 130 per cent compared to the net profit of AED461 million in 2004. The profit for the bank, including depositors' profits, showed a 7 per cent increase for the year ending 31 December 2005 at AED2 billion, compared to AED1,017 million for 2004. The bank has been productive in creating partnerships and alliances at local as well as international level. It has adopted an aggressive expansion strategy, which started with the establishment of DIB Pakistan Limited, a wholly owned subsidiary of DIB. The bank has also comanaged Pakistan's US\$600 million first sovereign Islamic bond issue that has received a tremendous response from investors (Middle East Business Information, 2007).

Dubai Islamic Bank's financial results for 2006 have shown robust and expanding business across its operations. The bank reported AED1,56 billion in net profit for the year ending 31 December 31 2006, rising by 47 per cent compared to AED1,06 billion for the year ending 31 December 2005. At a meeting of the board of directors on 21 January 21 2007 a bonus share of 7 per cent and a cash dividend of 35 per cent was proposed. The profit for 2006, including depositors' profits, stood at AED3,3 billion, an increase of 65 per cent compared to AED 2 billion for the year ending 31 December 2005. In 2006 total assets reached AED64,5 billion; an increase of 50 per cent compared to AED43 billion in 2005. Financing and investment operations also showed strong growth with total investment and financing assets including investments in sukuks standing at AED38,8 billion; an increase of 28 per cent over 2005. Customer deposits also showed an aggressive growth of 43 per cent over 2005, reaching AED47,7 billion in 2006.

For the fourth quarter of 2006 the bank reported a net profit of AED540 million, an increase of 114 per cent compared to AED252 million over the corresponding period in 2005 (Middle East Business Information, 2007). Dr Mohammed Khalfan Bin Khirbash, the Minister of State for Finance and Industry and chairman of DIB, said in his 2006 Annual Report speech that year 2006 was a landmark year in Dubai Islamic Bank's history with immense contributions from all employees. He further reiterated that DIB signalled another year of excellence as it aggressively moved forward in the local, regional and international areas. The bank had expanded in the UAE and internationally which was indicative of it strengthening its position as a leader in banking and financing activities. The DIB report states that the bank achieved impressive results for the first quarter of 2007 with net profits reaching AED424,50 million; an increase of 27,8 per cent compared to AED332,04 million over the corresponding period in 2006. Total income grew with 37,6 per cent to AED1,23 billion from AED894 million over the corresponding quarter in the previous year. The bank's basic and diluted EPS (earnings per share) attributable to the shareholders of the parent company grew with 16,7 per cent to AED0,14 from AED0,12 (Dubai Islamic Bank, 2007).

DIB is reputed for its innovative products and electronic banking platform. The bank has won appreciation from many quarters. In May 2007 the Banker ME Magazine honoured it with the Best Islamic Bank Award for the third consecutive year. In March 2007 it was conferred the Dubai Human Development Award. It was also recognised as Euro Money's Best Islamic Bank in the Middle East in February 2007 and earlier in January it was also named as the Best Islamic Finance House in the United Arab Emirates during the Islamic Real Estate Finance Conference (Dubai Islamic Bank, 2007).

### **4.6.3 Al Baraka Bank South Africa**

Al Baraka Bank Ltd in South Africa was established in terms of the Banks Act 23 of 1964 with its registered head office in Durban; the bank officially opened its doors in March 1990. It is a subsidiary of the Al Barakah Banking Group (ABG), which is the world's leading Islamic banking group based in Bahrain. The group had subsidiary banking units in ten countries worldwide which in turn have in excess of 200 branches. Local and international investors jointly own the bank. Al Baraka Bank's board comprises both local and international business people with individual professional and management abilities and collective expertise in the Islamic banking industry.

The bank's products and services promote the understanding and adoption of Islamic business principles and so contribute to the socioeconomic development of the community. Since its inception the bank has shown impressive growth. Such growth and its overall development may be attributed to the niche market's faith and confidence in its ability to implement and further develop a viable alternative to interest-based banking in South Africa. Today the bank has branches in Durban, Johannesburg, Pretoria and Cape Town. Its vision is to be an institution that endeavours to reflect the Islamic economic system in all its activities while its mission is to become the leader in the promotion of socioeconomic development through the application of Islamic economic principles and values, providing optimum returns to shareholders and investors through partnership banking on a risk reward sharing basis (Al Baraka Bank Annual Report, 2006).

- **Review of operations**

The bank was established in 1990 with an authorised capital of R10 million fully paid. The bank was successful in achieving good rates of deposits, which increased from R5 million in 1991 to R34 million in 1992. Bank investment

increased from R17 million in 1991 to R48 million in 1992. The bank also realised profits of approximately R1,2 million in 1992 without having to wait for a break-even point as is usual. A branch of the Al Baraka Bank was opened in Cape Town in response to the desires of the Muslims of that region. The bank was adamant that all its investments, instruments, policies and services be directed to the benefit of the Muslim minority. Some of the South African investment and service trends included, for instance, the development of Small Industrial Projects; the bank started the development of small businesses and industries through the financing of such projects according to Islamic methods such as Musharaka and Mudarabah transactions. The bank provided the required technical assistance enabling the small family businesses to become productive, and turning employees into owners of private enterprises directed towards their own interests. These projects assisted in rising the living standards of Muslim communities. In this regard the Albaraka Hajj Investment scheme must also be mentioned: one of the leading projects for the assistance of the Muslim minority in South Africa. Under this scheme accounts are opened for individuals with a specified minimum amount to which regular amounts are added over a specified period of time; such amounts are invested as soon as they are placed in the bank. The profits realised are credited to the account until the amount reaches a certain percentage of the total cost of the Hajj journey whereupon the client is allowed to make the Hajj journey (pilgrimage to Mecca) during which he or she is provided with facilities, privileges and special deductions (Finance in Islam, 2005).

As regards banking control it became evident from the discussion with a certain bank manager, who preferred to remain anonymous, that the Al Baraka Bank is subjected to the same banking controls as those applicable to the conventional banks. In other words, it complies with the Banks Act and also adheres to all the ratios as prescribed by the South African Reserve Bank, such as its cash reserves and liquid asset ratios in order to meet its

obligation towards depositors' demand for withdrawal. However, in respect of its liquid asset requirements the bank will only hold onto those liquid assets that are not interest bearing. Short-term instruments like treasury bills, government bonds and bankers' acceptances that are normally available to conventional banks are not held by this Islamic bank since they are all interest based. It became clear from the discussion that this somewhat jeopardises the bank's profit yielding capacity since funds are lying idle and hence the pressing need to find suitable Islamic financial assets devoid of interest. In this regard it was mentioned that some research on how to establish this is currently underway.

The bank currently provides the following services:

- **Investment**

- Savings Investment Account  
Profit-sharing savings account that allows investors to deposit and withdraw funds as required.
- Participation Account  
A profit-sharing account in which funds are invested for a fixed period and are available at maturity.
- Monthly Investment Plan  
A long-term savings scheme in which a specific amount is invested on a monthly basis.
- Regular Income Provider  
A profit-sharing investment account that pays out profits monthly on a lump sum investment.

- Junior Jumps Account  
A savings account for young investors interested in earning profits and controlling their own finances.
- Al Baraka Transaction Account  
A convenient day-to-day account to easily manage one's money.
- Future Growth Al Baraka Equity Fund Unit Trust  
A Sharia-compliant opportunity to invest in the stock exchange.
- **Financing**
  - Trade  
Provides trade financing to manufacturers, importers and entrepreneurs in other types of industry that generate profit from trade. The Murabaha (instalment sale) resorts under this category.
  - Transactions consisting of fixed instalments repaid over an agreed period at a preagreed percentage markup.
  - Motor Vehicle Finance  
Provides motor vehicle financing for personal vehicles or a fleet of vehicles for business .
  - Residential and Commercial Property Finance  
Provides residential property finance and commercial property finance through Murabaha (instalment sale). Mode of financing where a fixed instalment is repaid over an agreed period.
  - Asset-based Finance  
Here the bank finances the purchase of equipment and machinery for a company using the Murabaha mode of financing.

- **Financial Services**

- Estate Planning and Administration of Estates

The bank provides a comprehensive service for the drawing up of wills and the administration of individual estates.

- Stainless Steel Tank Containers

This is an asset-based investment opportunity that the bank provides to earn a steady off-share income.

- Takafol Asset Protection

The Takafol Waaf Fund is a scheme based on brotherhood solidarity and assistance, providing financial aid to participants in need. It protects individual's assets such as property, furniture and equipment as well as motor vehicles. The fund's investments are Sharia-compliant and any declared surplus is distributed among participants.

- Foreign Exchange Services

Al Baraka Bank, in association with Rennie's, offers a host of foreign exchange services for travellers.

- **Other services**

Provides an online statement system (Al Baraka Marketing Department Information Division, 2007).

The Chief Executive Officer of Al Baraka Bank, Mr Shabir Chohan, indicated in the Annual Report 2006 that the bank realised a net income before taxation of R15,3 million over the 2006 financial year, against R10,2 million over the 2005 financial year; a growth of 50,6 per cent which is a clear indication of both the bank's growing acceptance within the niche market and also its ability to continue expansion in a challenging environment. He was further

pleased to note the growth experienced during the review period, that the bank's assets grew by 24,7 per cent to R1,5 billion by the end of the financial year whilst deposits strengthened by 24,7% to R1,3 billion. Advances showed growth of 28,8 per cent over the previous year, to R 1,3 billion. During the 2006 financial year the bank declared a dividend of 20c per share to all shareholders. Some of the achievements of the Al Baraka Bank during the 2006 financial period as well as its future strategy at that point in time are summarised below:

- **Achievements 2006**

- Implementation of the branch teller automation solution known as Cashier 9 in the Durban, Athlone and Laudium branches spanning three national regions.
- Electronic signature verification  
This was successfully introduced at the Durban, Athlone and Laudium branches in parallel with the cashier 9 implementation.
- The Online statement system  
This system enables customers to log in securely over the internet.
- Basel II objectives  
The bank adopted a structured and dedicated project approach in addressing its Basel II objectives The banking group is committed to comply with internationally established principles and policies in relation to management. In particular the bank fully subscribes to the guiding principles of risk management as set down for Islamic Financial Services Institutions by the Islamic Services Board, and of course also to the need for a comprehensive risk management and reporting process. The responsibility for the formulation and monitoring

of the bank's policies relating to all aspects of risk, the developing of the framework of risk management and the coordination of the implementation of Basel II is vested with the Al Baraka Group Head of Credit and Risk Management. This person is also in charge of introducing risk measurement software, the monitoring of the bank's compliance with risk measurement standards and providing Group Management with reports in respect of the bank's risk-adjusted return on capital.

The bank's board of directors defines and sets the bank's overall levels of risk appetite, risk diversification and asset allocation strategies that apply to each Islamic financing instrument, economic activity, geographical spread, currency and tenor. Each of the banking group's subsidiaries is managed by its respective board of directors. The group subsidiaries follow documented policies such as credit policies and procedures which were in the process of being updated to reflect the new group-wide policies, thereby ensuring that sound risk management is in place in all units of the banking group.

An extensive review of the banking group's risk management framework was carried out in 2008 by an independent risk management expert which resulted in a very satisfactory rating being awarded for risk management at the group level.

At the subsidiary level, as at 1 January 2008 three banks had met their respective central bank's requirements relating to Pillar 2 of Basel II. The remainder are at various stages of system development and introduction of policies and procedures as required by their respective regulators.

Al Baraka Group anticipated completing in early 2009 the selection process in respect of a consolidating system that is in accordance with Basel II requirements. At present all relevant information that is required for consolidation purposes is provided by subsidiaries by way of a web-based intranet application; however, in the near future by implementing the proposed consolidation system the required data would be automatically retrieved at the Head Office.

In respect of Basel II's capital adequacy disclosure, the Basel II requirements under Regulation 43(1)(e)(ii) relating to banks requires minimum disclosure on the capital adequacy of the bank on a quarterly basis. This announcement meets the ongoing reporting requirement for quarterly disclosure in terms of Pillar 3 of the Basel II capital accord. On 31 December 2010 Al Baraka Bank had a total capital adequacy ratio of 10,14 per cent (compared to 9,91 per cent in September 2010) and a Tier 1 capital adequacy ratio of 9,86 per cent (compared to 9,65 per cent in September 2010) (Albaraka Banking Group, 2011).

- Upgrading of central server  
During 2006 the central server was upgraded to the latest IBM Power 5 series server, effectively doubling storage capacity whilst quadrupling processing performance.
- Establishment of a sound disaster recovering system  
The establishment and availability of a sound disaster recovery system to ensure business continuity in times of crisis has been stepped up.
- Core banking systems  
The core banking systems that have been employed over the years are currently under review with a view to considering more suitable systems in the light of medium- to long-term requirements.

- **Future strategies**

- Network and infrastructure upgrade

The Bank is undertaking network and infrastructure upgrades on a national basis to accommodate higher traffic volumes and improve branch application systems' response times.

- The replacement of core banking systems

- Internet banking

Investigations are under way to introduce electronic transaction processing and Internet banking as part of the bank's online service offerings.

- Branch automation

Branch automation is receiving attention, incorporating the Cashier 9 teller and electronic signature verification systems. The implementation of the branch teller automation solution is known as Cashier 9 (Annual Al Baraka Report, 2006).

#### **4.7 ISLAMIC BANKING WINDOWS WITHIN CONVENTIONAL BANKS**

There are certain interest-based institutions in South Africa that have opened an Islamic banking window and have commenced offering Islamic banking products since 2006. An example of this is Absa, South Africa's largest retail bank, owned by Barclays, one of the world's largest banking groups, who have founded Absa Islamic Bank.

According to the Marketing and Communication division of Absa Islamic Bank (2009) the Bank offers products and services based on Sharia law which are free

from any unlawful components like interest providing banking solutions based on its clients' needs. Some of its product offerings are mentioned below:

- **The Islamic savings account**

This is an account based on the Mudarabah (profit share) principle. The client deposits money and Absa Islamic Bank manages the money. The parties agree on a prearranged profit-sharing ratio. This is a full transactional account which is accessible 24/7, offering the client facilities of interest-free and cellphone banking.

- **The Islamic target save account**

This is an account based on the Mudarabah (profit share) principle. The client deposits money and Absa Islamic Bank manages the money. The parties agree on a profit-sharing ratio. This is a structured savings account and a minimum of R100 has to be deposited every month; the client is allowed four withdrawals a year.

- **The Islamic cheque account**

This account is based on the Qardh (loan) principle. There is no profit share and no overdraft facility. The client may obtain a cheque book and this too is a fully transactional account which and is accessible 24/7 via internet, cellphone or the branches. A minimum of R500 is required to keep the account open.

- **Islamic asset and vehicle finance**

This service is based on the Ijarah (leasing) principle in Sharia law. The item to be leased is purchased by the bank and then leased to the client over a fixed period of time with a fixed rental. The client has the option to purchase the asset.

- **The Islamic will**

A client may request an Islamic will which would then be drafted by the Absa Trust and sent to the Absa Islamic Bank division for review; if Sharia-compliant the client will sign the will. The current cost for this service is R342 with an additional cost of R60 per annum for safekeeping of the will. The client is entitled to a 15 per cent discount on executor's fees.

- **Islamic fixed-term deposit**

A client enters into an agreement with Absa Islamic Bank whereby the bank purchases equity or other Sharia-compliant commodities and then sells them; any profit is shared between Absa Islamic Bank and the client. The minimum amount to be invested is R500 000.

- **International banking**

Absa Islamic Bank offers the following Sharia-complaints products: cash passport, foreign currencies and travellers' cheques.

- **New gold**

An opportunity to invest in gold bullion.

- **Takafol**

This product offers Sharia-compliant domestic, vehicle and commercial insurance cover. The Islamic banking products are designed in accordance with Islamic law and this system of banking does not exclude any person from utilising its products. Funds and revenue as per Islamic banking transactions are separated from interest-based transactions. The bank's Sharia supervisory board directs, approves, reviews, supervises and monitors the activities of Absa Islamic Bank to ensure compliance with Sharia law. This is an independent supervisory board of specialist Islamic jurists whose rulings are binding on the Islamic bank.

#### 4.8 FACTORS OF CRITICAL IMPORTANCE FOR THE SUCCESS OF ISLAMIC WINDOWS OPERATING WITHIN CONVENTIONAL BANKING SYSTEMS

The success of Islamic windows within the conventional banking system depends on the acceptance thereof by the Muslim public. The general perception that is prevalent is that it is not viable to have permissible and non-permissible transactions under the same roof, as the danger of contamination is a real possibility. This matter could be another area of research in itself.

Sungard (2008) asserts that some factors are of critical importance for its success, namely:

- Newly formed Islamic banks and conventional banks who are opening Islamic windows need to maintain compliance with Sharia law.
- The bank needs to appoint a Sharia board or a Sharia counsellor to ensure conformity and minimise Sharia risk. These boards and counsellors should be carefully selected based upon their reputation or experience within a given market.
- Both pure Islamic banks and conventional banks operating Islamic banking windows also need to address their risks. Not only should these institutions have to cover the same risks as wholly conventional banks but Sharia banks must cover additional risks, including the following:
  - *Commodities and inventory risks* (from holding items in inventory in terms of a Murabaha contract or with intent to lease under an Ijarah
  - *Legal and sharia compliance risk* due to an additional set of laws and rules. There is the likelihood that Sharia-compliant

banks will enter into additional contractual agreements. In the event that something goes sour, the issue may end up being taken to a secular court unfamiliar with Sharia law, exposing the Bank to risk.

- *Equity position risk* from equity in Mudarabah financing contracts.
- *Mark-up risks* since Islamic banks use market rates as opposed to interest to benchmark their product pricing. As a result there is a risk associated with any changes to the benchmark rate.
- *Contamination risks*. Islamic Bank and conventional banks maintaining banking operations should not allow non-Islamic funds to commingle with Islamic funds per Sharia law. Conventional banks operating Islamic windows must maintain a separate balance sheet and financial books and participate strictly only in Islamic-compliant investments. Those funds intended for Sharia-compatible investments should not be mixed with non-Islamic investments so that the purity of Islamic transactions and banking practices are maintained.

Certain pressing issues facing the Islamic banking community should be addressed and researched, for instance the need for short-term money market investments and tools for liquidity management.

#### **4.9 SUMMARY**

Islamic banking, whilst it absolutely forbids transactions on the basis of Riba, permits the principles of profit and loss sharing in all modes of business transactions. In fact, Islamic banking is essentially based on the principles of

profit and loss sharing (PLS) which allows for conforming to Islamic ethical principles. The fundamental sources of Islam, the Quran and the Sunnah of the Prophet, provide guidelines for economic behaviour and a blueprint of how the economic system of Muslim society should be organised. Therefore the values and objectives of all Islamic economic systems must necessarily conform to and comply with the principles derived from these fundamental sources. The economic system of Islam does not revolve round arithmetical calculations and capacities of production alone. Rather it is drawn up and conceived in the light of a comprehensive system of moral guidelines and principles. Business transactions enjoy a great deal of attention in Islam, for honest trade is seen as permitted and blessed by God. In respect of the Islamic banking movement, the first reported experiment with profit and loss sharing (PLS) on a significant scale was rurally based and was started in the early 1060s in the town of Mit Ghamr, Egypt. The Egyptian success in Islamic banking attracted the attention of other Muslim nations, particularly Saudi Arabia and the Gulf states. The Faisal Islamic Bank of Egypt was established in 1977 whilst the first Islamic Bank in the Gulf was the Dubai Islamic Bank established in 1975. Islamic Banking is a new phenomenon that has taken many observers by surprise; however,, the current position is that there are more than 200 Islamic financial institutions all over the world with investment funds in excess of 250 billion US dollars. In some Muslim countries total or partial transformation has taken place in favour of Islamic banking. At present Islamic banking has gained approval by many international financial institutions, professional bankers and academics. It seems that Islamic banking has established its identity and certainly it seems here to stay, grow and develop into a competitive alternative to interest-based financial enterprises.

The concept of profit and loss sharing seems to be the main Islamic alternative for the functioning of commercial banks, investment companies and any other business, interest being strictly prohibited in Islamic systems. Capital in Islam is not considered as a separate factor of production; it combines with enterprise in a relationship of profit and loss sharing. This form of business relationship is

technically called Mudarabah; an arrangement where people with surplus funds entrust these to those who have the skills and experience to utilise it for productive purposes. Unlike the interest-based system the amount of return on the funds invested in Mudarabah is neither fixed nor predetermined. The quantum of profit or loss depends on the operational results of the economic activity undertaken. From the literature study it seems permissible to distribute the profits amongst the providers of funds and the entrepreneurs in any agreed proportions. In case of loss, however, the amount of loss is shared by the providers of funds only in strict proportion to the capital provided by each. Thus a partner who has contributed his skills only and did not provide any capital may share in the profits but not in the normal losses of the business. This seems to be based on the principle that a burden shall be borne according to each one's capacity. Losses occurring due to negligence or breach of agreement by the Mudarib (managing trustee) should however be borne by that person.

In the next chapter the primary focus will be on the procedures that will be employed in collecting data related to the issues under research. In this regard matters such as the selection of data sources, selection, preparation and administration of research methodology instruments used will be covered.

## **CHAPTER 5: EMPIRICAL STUDY**

### **5.1 INTRODUCTION**

The theory regarding the principles underlying modern banking, a general framework of Islamic law, the fundamental principles on which Islamic banking is based, and the Islamic banking movement as it started off in different countries were topics discussed in the previous chapter.

In this chapter the following will be discussed: the research methodology in terms of the selection of data sources, the manner of acquiring the necessary information, the questionnaire design and the rationale behind each question included in the questionnaire.

### **5.2 RESEARCH METHODOLOGY**

Tustin (2005:89) states that there are two main approaches to research, namely the quantitative and qualitative research approach. Quantitative research generally involves the collection of primary data from large numbers of individuals and then the results are projected to a wide population. On the other hand qualitative research generates data that are frequently difficult to quantify. This research approach implies a personal value judgement approach from which it is difficult to draw any collective general conclusions. It is further asserted that this kind of research seeks insight through a less structured and a more flexible approach.

The methodology employed in this study is qualitative research. In this study which investigates the viability of an Islamic bank in accordance with certain laws and regulations, a qualitative research approach is more appropriate. It will secure the necessary information, views and experience from the various parties in the research population. The following two steps have been employed in this

study:

- the first step entails the selection of data sources;
- the second step entails the methods employed to acquire the necessary information.

Another research method that was followed was a case study approach and the following banks were scrutinised:

- 1) the Faisal Islamic bank of Egypt
- 2) the Dubai Islamic bank
- 3) the Al Baraka Bank in South Africa

The two foreign banks were selected because it appears that they function according to Islamic principles side by side with the conventional interest-based banks and hence the question of their survivability within the ambit of competition comes to the fore. Data and information has been collected and organised in such a way as to structure a case study for each of the above enterprises. The data have been analysed and interpreted in respect of the modes of investment of these banks and their compliance with Islamic Sharia principles as well as their profitability.

## **5.3 RESEARCH METHODOLOGY STEPS**

### **5.3.1 Step 1: Selection of data sources**

The population that was selected for this study were the small- and medium-sized businesses of Muslim entrepreneurs in the Tshwane area, Islamic bankers and Islamic religious leaders.

The following groups of respondents were contacted and their views and

experiences have been invaluable in assisting in the construction of a model for Islamic banking and its survival potential within the South African economic environment. This model will be discussed in chapter 7.

- Muslim business people

Business people from the greater Tshwane and surrounding areas were contacted to determine whether they would be prepared to supply the funds for the successful operation of an Islamic bank in Tshwane. Initially it was intended that a representative sample of the population would be surveyed because it would not be feasible to study the whole population. The target population were Muslim-owned small- and medium-sized businesses (SMEs) in the Tshwane area. According to Mngomezulu (2002:11) these businesses typically show the following characteristics:

- 1 The owners are directly involved in the management of the enterprise.
- 2 The enterprise employs less than 100 employees.
- 3 The annual turnover of the enterprise is less than R 5 million.
- 4 The total capacity assets of the business amount to less than R 1 million.
- 5 There are no more than five units (or branches) of the industry.

The White Paper on Small Businesses (South Africa 1995:9) classifies businesses as micro-, small- or medium-sized, based on the following criteria: management, turnover, number of permanent employees and registration requirements. A micro-sized business is therefore classified as a business managed by the owner and employing one or two other permanent employees. Small businesses can also be owner managed and employ between five and fifty people. A medium-sized business employs between 51 and 200 employees. Businesses with more than 200 employees are regarded as large businesses. A sample of 10 per cent was targeted initially and the intention was to use the

random sample method and to target every tenth SME on the list.

However, it proved to be impossible to obtain a sample frame of Muslim-owned SMEs. Contact was therefore made with the Chamber of Commerce who furnished a short list of registered small-, medium-sized and micro-sized enterprises (SMMEs) in Tshwane and its surrounding areas, but Muslim-owned SMMEs on this list numbered only five. The Chamber of Commerce advised to contact the Tshwane Metropolitan Municipality. Upon contact with the municipality, a list of registered SMMEs was obtained but the list contained only eleven Muslim registered SMMEs, which included those five also registered with the Chamber of Commerce. As a consequence it was decided to interview all eleven Muslim-owned SMMEs and then eliminate those enterprises which did not conform to the prior definition of small- and medium-sized enterprises. Of the eleven registered SMMEs identified, only six were willing to be interviewed. Of the five non-respondents, two respondents could not be contacted, two refused to be interviewed, citing their reason as “we are very busy and sorry some other time”. One promised to come back on the matter but never did so, despite repeated calls on his cell phone and leaving SMS messages. All six entrepreneurs who agreed to be interviewed fell within the definition of SMEs in terms of their number of employees. It was then decided to implement the snowballing sampling technique to increase the sample size. According to Vermeulen (1998:55) the snowballing sampling technique involves approaching a single case or individual who is involved in the phenomenon to be investigated to gain particulars of other similar persons. In turn this person is again requested to identify further people who could possibly assist in making up the sample. Therefore to increase the sample size additional respondents were secured from those interviewed so that a total number of twenty respondents were targeted.

- Islamic bankers

Attempts were made to secure information from bankers who had experience in

Islamic banking and in particular in the following areas of banking: establishment of such a bank, operational issues, product offerings and financial instruments. Banking contacts assisted in identifying three individuals who have vast experience in the field of Islamic banking and who were also associated with the Al Baraka Bank. It was envisaged that their input would be invaluable. All three these respondents preferred to remain anonymous and information was obtained under the condition that their identity would be kept confidential.

- Religious leaders

Religious leaders were contacted so as to ensure that the envisaged Islamic banking enterprise would strictly adhere to Islamic principles. In Tshwane there are many Islamic religious leaders; however, their specialisation areas are not all the same. For purposes of this study it was important to secure interviews with those religious leaders who have expertise in the field of Islamic economics, finance or banking. Three such leaders who are well reputed in the field of Islamic law, economics and banking were identified. They are all considered to be religious experts who give advice and guidance on all matters requiring the application of Islamic principles. The religious leaders who were interviewed have been given the status of Muftis, who are categorised as learned theologians qualified to give rulings which are binding on contentious Islamic issues. They have to attend Islamic institutions of religious learning for a period of at least seven years before such a status is conferred onto them. They have studied the Holy Quran and its meaning in detail, as well as Arabic and Islamic law and jurisprudence. They are also Hafiz of the Quran, in other words, they have memorised the whole Quran. All three of them also have postgraduate qualifications: two of them have Honours degrees; one in Islamic economics and the other in Islamic Studies from a South African University. The other has a Master's degree in Islamic Studies and has also written a number of books on topics relevant to this discussion.

### 5.3.2 Step 2: Methods of acquiring the necessary information

Personal interviews have been conducted to determine the general trends and impressions towards the functioning, compliance with Islamic principles, operational procedures and strategies of Islamic banking. The personal interview system as a mode of contact was used because it is the most convenient and effective way of soliciting the views and experiences of the respondents. A list of critical questions for the different groups of interviewees was also formulated. These will now be discussed in more detail.

Welman and Kruger (1999:164-165) argue that the use of personal interviews and especially of structured interviews has several advantages and disadvantages. Briefly they are the following:

**Cost and ease of application.** The advantage here is the flexibility and adaptability, whilst its high cost is a disadvantage.

**Control over responses.** It is an advantage that interviewers are in complete control of the interview situation. The interviewer is in a position to notice and to clear up any misunderstanding immediately. If respondents are evasive, then interviewers can attempt to gain their confidence. The response rate is higher; there is less chance of the respondent avoiding the interview. There are no important disadvantages except that respondents cannot stay anonymous

Vermeulen (1998:63) highlights the following as characteristic of the structured interview:

- The questions and their order are planned in advance.
- The formulation of the questions is standardised.
- Clear directions are given for the reformulation of questions.

- The input of different interviewers is standardised by the adoption of a uniform approach.
- Because of the standard approach the responses can be easily classified and analysed.
- A structured interview is similar to an oral questionnaire.

A structured interview (based on the questionnaire) was used to acquire the necessary information. The interview system was used to determine the general trends and impression towards the functioning, compliance with Islamic principles, operational procedures and strategies of Islamic banks. This mode of contact seemed to be the most convenient and effective way of soliciting the views and experiences of the respondents.

Respondents were all within easy reach and did not comprise a very large number of individuals. Lists of critical questions for the different groups of interviewees were formulated. A further decision was taken to have the pilot questionnaires tested on a selected group of individuals. The individuals selected were the Muslim business people, the Islamic bankers and the Islamic religious leaders. A pilot study of the questionnaire was conducted to carefully select and adjust the questions in order to eliminate ambiguous questions and improve the clarity of unclear questions. Every precaution was taken to ensure that questions were understood correctly, that no biased questions were included and that good quality answers would be obtained. The information forthcoming from these contacts together with ideas derived from the literature were then used to modify the questions before administering them to the respective group of respondents. There were no material changes made to the questionnaire as a result of the testing phase and hence this questionnaire was used on the selected respondents

Three different sets of questions were formulated. The questions and discussion generated during the interviews were directed at specific areas related to Islamic

banking.

The questions directed to the Islamic bankers revolved around objectives of Islamic banking, operational mechanics, rules governing the activities of the bank, management of the bank and legal consulting. These respondents were categorised as Islamic bankers because they work in an Islamic banking environment like the Al Baraka Bank where they hold key positions; hence their input was regarded as invaluable. On the other hand the Muslim business people or entrepreneurs interviewed are engaged in running small- and medium-sized business enterprises and have many years of experience in the business environment.

The questions directed to the Muslim business people revolved around issues to determine whether or not they would support an Islamic bank to be established in the Tshwane area. The questions revolved around specific issues, such as support of existing commercial banks, legality of an interest-based approach within the context of one's religion, Islamic banks operating on a profit and loss sharing basis, other services provided by Islamic banks, financing of transactions in conflict with Islamic injunctions, establishment of Islamic banking as breakthrough for the whole community, and any suggestions with a view to attracting funds.

The questions directed to the religious leaders also revolved around specific areas, such as religious leaders' views on interest, views on hoarding, views on trade, profit and loss sharing, the basis of an Islamic banking model, legality of the various modes of financing, other banking services, the Religious Supervisory Board, legality of various liquid asset instruments, and finally suggestions offered for the successful operation of an Islamic Bank in the Tshwane area.

Each person was contacted by telephone and a meeting at a time convenient to

the interviewee was arranged. As far as possible attempts were made to secure the interview at the respondent's place of employment. The interviews with each respondent were scheduled to last for approximately 45 minutes. The format pursued in each case was very similar. Each interview was prefaced with a general introduction by the interviewer in which the purpose and scope of the study was outlined and an opportunity was provided for interviewees to ask questions or seek explanations. A balanced number of close-ended and open-ended questions were put to the interviewee and further questions were generated from the responses of those being interviewed. The views of the respondents were summarised and entered in the prepared questionnaire. Any general comments made by the respondents that were worthy of being noted were entered under a general comments section or else summarised and entered on a blank sheet. The interviews were conducted during the months of January, February and March 2007.

Consequently an attempt has been made to integrate the outcomes of the literature study with these qualitative data to construct a simple model of an Islamic bank within the South African economic context.

### **5.3.3 Questionnaire and questionnaire design**

This part of the study is based on the following forms of data collection:

- A questionnaire survey of Muslim business people that provided for a structured interview to be conducted
- A questionnaire survey of Islamic bankers that provided for a structured interview to be conducted
- A questionnaire survey of Islamic religious leaders that provided for a structured interview to be conducted

The rationale for and design of each of these questionnaires will be discussed

briefly in the following sections.

*The rationale behind the design of the questionnaire to Muslim business people*

The main focus of the questionnaire directed to business people revolved around issues to determine whether or not they would support an Islamic banking enterprise in the greater Tshwane area. The different sections of the questionnaire are discussed here briefly.

- A) Some basic questions related to the profile of the Islamic business enterprise:

*Question 1: Is the business privately owned?*

*Question 2: Is the business managed by the owner?*

*Question 3: Is part of the capital supplied by the owner?*

*Question 4: If the answer is YES, what part of the capital is supplied by the owner?*

*Question 5: How many people are employed by the business?*

*Question 6: Indicate the nature of your business.*

**Question 1-6**

The above six questions in section A dealt with certain basic information relating to the business enterprise, such as ownership, management, capital supply, number of employees, and nature of the business. The intention in asking these questions bears relevance as it is deemed to be of key importance in ascertaining the capacity of the businesses.

- B) Questions on support of the existing commercial banks

*Question 7: At present are you using the facilities provided by the existing*

*commercial banks like the current, savings and the fixed deposit account?*

*Question 8: Could you please rank the type of facility that you consider important and give reasons for selection?*

*Current, savings, fixed deposit, other accounts under the following headings:*

*Very important, reasonably important, important, not important, completely unimportant*

### **Question 7-8**

The intention of asking the questions in this section was to establish whether or not the businessmen are currently using facilities provided by the existing commercial banks. Respondents were given a list of three accounts and were asked to choose the account which they considered most important in respect of their business dealings. These two questions can be viewed as important as they would give an indication to the type of facility an Islamic bank should offer if they hoped to gain the support of the Muslim business people.

- C) Legality of interest within the context of one's religious beliefs

*Question 9: Does Islam prohibit dealings in interest transactions?*

### **Question 9**

This section attempted to establish whether the receiving and paying of interest would be permissible within the context of the respondent's

religious beliefs.

D) Support of an Islamic bank

*Question 10: Would you support an Islamic Bank which will provide banking services and at the same time avoid any interest dealings?*

*Question 11: What would you say be the main reason to keep funds in the Islamic bank? Tick the appropriate category*

- Avoidance of interest*
- Offer good yield on capital*
- Dependable and trustworthy*
- Contributes to the welfare of the Muslim*

*Question 12: Would you support an Islamic bank operating on strict Islamic principles that does not offer a predetermined interest rate but allows you to share in the profit or loss on funds deposited with them? Give reasons.*

**Question 10-12**

These questions were asked to determine whether the respondents would support an Islamic bank if the very same facilities were offered to them as those of interest-based banks and to ascertain what would be the main reasons to keep funds with the Islamic bank. Respondents were asked to offer their views on or opinions of an Islamic bank primarily entering into a profit and loss agreement with its depositors. It needs to be mentioned that the respondents were briefed as to the manner in which the bank would operate before eliciting their opinion.

E) Other services

*Question 13: Would you also avail yourself of the other services provided by the Islamic bank e.g. Safe custody of valuables, purchase and sale of foreign currency?*

*Question 14: Would you have any objection to paying a fee for such service?*

**Question 13-14**

The objective in asking these questions was to ascertain the respondents' support of an Islamic bank in respect of the services offered. It could very well be that the respondents would opt for a certain service from the Islamic bank and then also at the same time use other services provided by interest-based banks. The reason for asking this question was also that an Islamic bank is highly unlikely to make any profit from lending and hence the need to provide other services where the banks own money is not involved in the generation of profit.

F) Support for interest-based bank apart from an Islamic bank

*Question 15: Would you also support an interest based bank apart from the Islamic bank? Give reasons.*

*Question 16: Do you agree with the statement that "interest-based banking depositors are concerned only with a fixed return on their savings without much concern for the total operational results of banks?" Furnish reasons.*

*Question 17: Would you agree with the statement that "under Islamic*

*banking, the operational results of the banks will be of great concern to depositors since they share in the profit or loss? Furnish reasons for your response.*

**Question 15-17**

These questions were included in the interview to determine whether the respondents would also support an interest-based bank apart from the proposed Islamic bank. The underlying aim was to identify the reasons a person would advance to support an interest-based bank apart from the Islamic bank, if the Islamic bank were adequately meeting the banking needs of the respondents. In view of this the respondents were asked for reasons if they answered in the affirmative. The two statements which were considered important were put forth, though they might appear out of context. The importance of these questions is that it made it possible to establish whether the respondents all shared the same opinion in respect of these statements.

G) Financing transactions in conflict with Islamic injunctions

*Question 18: Will it matter if such a bank finances transactions relating to any non-Islamic activities? Give reasons.*

*Question 19: Would you prefer to have all the operations of the Islamic bank checked by a Religious Supervisory Board to ensure strict and continuous adherence to the Sharia? Give reasons.*

**Question 18-19**

These two questions were asked merely to determine whether the

respondents would view the matter of an Islamic bank financing transactions against Islamic principles or injunctions in a serious light or not, and also whether there was a need to establish a Religious Supervisory Board that would ensure strict and continuous adherence to Islamic Sharia.

H) Establishment of Islamic bank as a breakthrough for the community

*Question 20: Do you consider the establishment of an Islamic Bank in South Africa as a breakthrough for the Muslim community? Give reasons.*

**Question 20**

This question was included in the interview in an attempt to elicit information that would make it possible to determine whether the respondents would welcome the establishment of an Islamic bank.

I) Suggestions to Islamic bankers with a view to attracting funds

*Question 21: Are there any suggestions that you could offer to Islamic bankers with a view to attracting funds?*

**Question 21**

This open-ended question was asked to ascertain what suggestions respondents could offer to Islamic bankers with a view to attracting funds from members of the Muslim community.

### *The rationale behind the design of the questionnaire to Islamic bankers*

The main focus of this questionnaire was directed at ten broad sections relevant to Islamic banking. These sections can be loosely termed as follows: objectives of an Islamic bank, operational mechanics, banking controls, payment of Zakaat, types of investment, management and staffing, Islamic legal consulting, reaction of the South African banking authorities, major problems of Islamic banks and the priorities for the future.

The different sections of the questionnaire are discussed here briefly.

#### A) Objectives of Islamic banks

*Question 1: Name of bank or institution?*

*Question 2: When was the bank founded?*

*Question 3: What would you say is the main objective that influenced the bank to become Islamic? Tick the appropriate box*

- Economic*
- Ethical and / or justice*
- Religious*
- Political*

*Question 4: Briefly explain how do you intend to realise your objectives?*

#### **Question 1-4**

The aim in asking these questions was to elicit information as to the reasons for establishing the Al Baraka Islamic Bank: whether the motive was to apply Islamic Sharia principles only or also to compete with the interest-based banks in South Africa or merely to make money.

B) Operational mechanics

*Question 5: Would you please try to rank the account that may have been constituting the major liabilities of a bank?*

*Demand deposit, time deposit, investment deposit and other deposits, under the following categories:*

*Very important, reasonably important, important, not important, completely unimportant*

**Question 5**

The intention in asking this question was to establish which type of account offered by the Islamic bank constitutes the major liability of the bank.

C) Customers of the bank

*Question 6: Is the bank only open to members of the Muslim community? If the answer is NO then are there any non-Muslims who are clients of the bank?*

**Question 6**

The reason for asking this question was to establish whether the clientele of the bank was restricted to the members of the Muslim community.

D) Profit and loss sharing

*Question 7: Are depositors required to enter into a profit and loss sharing agreement with the bank?*

**Question 7**

The reason for asking this question was to determine whether depositors were required to enter into a profit and loss sharing agreement and if so, in respect of which deposits.

E) Financing techniques

*Question 8: Please rank the following financing techniques that are appropriate to your bank:*

*Musharaka, Murabaha, Ijara, Qard-ul-Hasna*

*under the following categories:*

- Very important*
- important*
- Less Important*
- Not important*

**Question 8**

This question attempted to establish which financing techniques are most often used by the bank.

F) Overdraft facilities

*Question 9: Does the Islamic bank give overdraft facilities? If YES, on what basis?*

**Question 9**

The reason for asking this question was to determine whether the Islamic bank grants overdraft facilities to its clients since this facility makes up a substantial portion of the business of conventional banks. Interest-based income on overdrafts forms a major component of the total income earned by a conventional bank.

G) Discounting of the Bills of Exchange and other banking services

*Question 10: Does the Islamic bank discount Bills of Exchange? If YES, then on what basis? How is the discount rate determined? Explain.*

*Question 11: Does the bank provide other banking services for its clients?*

*Question 12: Is a fee charged for these services?*

**Question 10-12**

The aim in asking these questions was to establish whether discounting of Bills of Exchange, which is a common practice of conventional banks, could also be lawfully undertaken by an Islamic bank.

H) Financial instruments for disbursement of short-term funds

*Question 13: The Islamic Bank depends for a substantial proportion of its resources on short term and liquid funds. Therefore it requires short-term instruments for realisation as well as disbursements of its short term funds. For an interest based bank these instruments are to be found in interbank operations, Treasury Bills, Government Bonds, and in various money market operations such as bankers' acceptance, Government Bonds and bill discounting. However, these to a great extent are interest-based and therefore not normally available to an Islamic bank, there is then this gap in the operation of the Islamic bank. How do you intend bridging this gap? Briefly explain.*

**Question 13**

The reason for asking this question was twofold: in the first place to determine whether or not the Islamic bank will hold on to certain short-term instruments like Treasury Bills, Government Bonds or bankers' acceptances which to a great extent are interest based. In the second place it was deemed necessary to determine how an Islamic bank would comply with the requirements of the Banks Act, the Basel II accord, other regulations in terms of liquidity and other requirements. The question is linked to question 14.

I) Banking controls

*Question 14: Is the Islamic Bank subjected to the same banking controls as applicable to the interest-based bank? If YES, then how will the bank comply with the liquid asset requirement?*

*Explain.*

**Question 14**

This question was aimed at determining whether or not an Islamic bank is subjected to the same banking controls as other traditional banks with specific reference to its compliance with the minimum liquid asset requirements.

J) Payment of Zakaat

*Question 15: How is the bank's annual payment of Zakaat (compulsory charity) paid? Explain*

*Question 16: Is such a payment tax-deductible?*

**Question 15-16**

The intention in asking these two questions was to establish how the bank would fulfil its Zakaat obligation.

K) Type of investments

*Question 17: What kind of projects do you mainly support financially?*

**Question 17**

The objective in respect of this question was to establish the type of project that the bank intends to support; that is whether medium- and long-term projects are financed where the uncertainty and risk are high and it takes longer to realise the return. However, in such projects there would

be a greater contribution towards the socioeconomic growth of the community and the provision of gainful employment when compared to short-term financing where the returns are quicker and just sufficient to provide for the entrepreneur and his family.

L) Management and staffing

*Question 18: Is the bank managed in the same manner as a joint stock company, in general by a board of directors elected in accordance with its articles of association?*

*Question 19: How is the Islamic bank staffed as regards any special categories of employees? Explain.*

*Question 20: Does the bank employ specialist personnel from the non-Muslim community? If YES explain.*

**Question 18-20**

These questions were aimed at establishing whether the bank would be managed by a board of directors as other companies are, or whether they could possibly use other management techniques; the aim being more to corroborate the fact that directors appointed by shareholders would manage the bank. The aim of the question was also to solicit information as to whether the bank as such would employ only people of the Islamic denomination or keep employment open to all religious denominations as long as employees have the required skill and expertise. If it is open to all denominations then perhaps this fact could also be used as a marketing tool to publicise the operative mechanics of Islamic banking to the non-Muslim community who are ignorant of this type of banking.

M) Legal consultant

*Question 21: Does the bank appoint an Islamic legal consultant?*

*Question 22: Does he possess any specific qualification?*

**Question 21-22**

The purpose of these two questions was to determine if the Islamic bank would employ an Islamic legal consultant so as to ensure all transactions are compliant to Islamic Sharia law and also to ascertain whether such a person should possess any special qualification.

N) Reaction of the South African banking authorities

*Question 23: What has been the response of the South African banking authorities to the establishment of an Islamic bank in South Africa?*

**Question 23**

The question was aimed at determining whether the Islamic bank has been met favourably by the South African banking authorities and whether or not there is any degree of support from them.

O) Major problems of the Islamic bank

*Question 24: What major problems are you confronted with in opening an Islamic bank in South Africa? Explain.*

*Question 25: In your opinion how can these problems be resolved?*

### **Question 24-25**

These two open-ended questions were aimed at eliciting information relating to any problem that the Islamic bank might have encountered in its establishment and whether there are any steps in place to resolve them.

- P) Priorities for the future

*Question 26: What are your priorities for the future?*

### **Question 26**

The aim of this question was to establish whether the bank would in future only focus on long-term investments with high yields so as to only secure good returns for itself and its shareholders and depositors, or whether it would also involve itself in the granting of interest-free loans to deserving members of the community in order to raise their standard of living, since Islam encourages helping the poor.

*The rationale behind the design of the questionnaire to Muslim religious leaders*

The main focus of the questionnaire directed to religious leaders was to ascertain whether the Islamic bank would strictly adhere to Islamic principles.

- A) Religious leaders' views on interest

*Question 1: What is the Islamic viewpoint on the receiving and paying of interest?*

*Question 2: Are the present conventional bank interest based?*

*Question 3: Does Islam consider it an act of sin, if one continues dealing on the basis of interest knowing it as being unlawful?*

*Question 4: Would it be considered an un-Islamic act where a Muslim businessman in South Africa conducts some of his business with an interest-based bank?*

*Question 5: If renting of money at a price is termed interest (Riba) why then is the renting of property at a price permissible?*

#### **Question 1-5**

The objective in putting forth these questions was to confirm certain issues such as the following: whether the religious leaders held the same definition of interest as found in the literature study; whether or not South African Islamic business people are committing an act of sin by supporting the present interest-based banks, and to get clearance on matters such as renting of money at a price and renting of property at a price where the former is normally considered unlawful and the latter lawful.

#### **B) Views on hoarding money**

*Question 6: Does Islam permit the hoarding of money (holding back money from circulation)?*

#### **Question 6**

This question was based on the assumption that if interest is unlawful,

whether it would be acceptable in an Islamic worldview to hoard money, thereby withdrawing it from circulation.

C) Views on trade

*Question 7: Does Islam permit trade?*

*Question 8: Would I be correct in saying that the earning of money through trade is permissible whilst earning through the lending of money at a price is forbidden?*

*Question 9: How did Prophet Muhammad (S.A.W) view trade? Please elaborate.*

**Question 7-9**

These three questions were aimed at eliciting information from the interviewees' responses as to Islam's attitude on trade.

D) Views on profit and loss sharing

*Question 10: Is it permissible for people with surplus money to entrust their funds to those who have skills and experience for utilising it for productive purposes?*

*Question 11: If YES, then would it be lawful for the suppliers of capital to share in the profit with the users of capital?*

*Question 12: Was this practised by the Holy Prophet Muhammad (S.A.W) during his lifetime? Please elaborate.*

*Question 13: In the event of there being a loss how should this be apportioned between the parties? Elaborate.*

**Question 10-13**

This group of questions aimed at determining whether it is acceptable in Islam for one party to supply capital and the other party to use his skills in some business venture, and then distribute the profit or loss realised in this venture in accordance with some predetermined rate. The objective in asking the above questions was also to confirm whether or not this was practised by the Holy Prophet Muhammad (SAW).

- E) Mudarabah as a form of business financing

*Question 14: The Islamic term used for this form of business financing is Mudarabah. Do you agree?*

*Question 15: Beside this mode of financing is it acceptable to devise other modes which avoid any interest dealing but permits trade?*

**Question 14-15**

The intention in asking these two questions was to establish whether the above kind of financing techniques entailing profit and loss sharing can be termed as Mudarabah, and also to confirm whether other modes of financing that avoid interest would be acceptable in Islam.

- F) Basis of an Islamic banking model

*Question 16: Do you agree that in respect of banking, a trade-based model of banking would be a plausible alternative to the*

*interest-based model?*

*Question 17: The establishment of an Islamic bank on the Mudarabah basis is acceptable. Do you agree?*

**Question 16-17**

These questions were aimed at determining whether Islamic religious leaders would approve of an Islamic banking model which would be trade based.

G) Various other modes of financing

*Question 18: Are the following modes of financing by Islamic banks lawful?*

*(a) The financing by lending (without interest or cost of funds) on which banks may recover actual service charges from time to time.*

*(b) The purchasing of goods by banks and their subsequent sale to clients at an appropriate mark-up price on a deferred payment basis (Murabaha).*

*(c) The leasing/renting of assets where the financing bank acquires equipment or buildings and rents them to the user against a fixed charge (Ijara).*

*(d) The equipment/buildings are bought by the financier for the user and rented out to him. The user agrees to deposit certain sums over an agreed period into an investment account with the bank. These sums are reinvested for the purchase of the items at an agreed price (Ijara wa Iqtina).*

*(e) One party invests capital which the other party uses for trade or investment. The profits are shared according to an agreed ratio. The losses are however deducted from the capital (Mudarabah).*

*(f) Funds are provided as equity or working capital or both and any profit or loss is shared according to an agreed ratio (Musharaka).*

*(g) Financing by lending without interest and without service charge (Qard-ul-Hasna).*

### **Question 18 (a)-(g)**

The sole aim in asking these questions was to determine the legality of the various modes of financing techniques as found in the literature survey and as practised by Islamic banks in other countries.

H) Other services

*Question 19: An Islamic bank that provides service for a fee, e.g. purchase and sale of foreign currency, safe custody of documents is possible.*

### **Question 19**

The intention of this question was to determine whether an Islamic bank would be justified in charging a fee for any other service that it may render, for instance to charge a fee for the purchase and sale of foreign currency, or for the safe custody of documents.

I) Religious Supervisory Board

*Question 20: Do you feel it is necessary that the Islamic bank appoints a Religious Supervisory Board to ensure all transactions adhere to strict compliance with Islamic Sharia? If YES, what in your opinion should be the qualification and main functions of such a board? Please elaborate.*

**Question 20**

The purpose of this question was to establish whether or not the appointment of a Religious Supervisory Board was essential to ensure strict and continuous adherence to the Sharia.

J) Legality of the various liquid assets

*Question 21: Are the following liquid assets dealing used by the conventional bank interest based?*

- *Treasury Bills*
- *Land Bank Bills*
- *Reserve Bank Debentures*
- *Negotiable Certificate deposits*
- *Bankers' acceptance*
- *Municipal stocks*
- *Government stocks*

**Question 21**

The main concern in asking this question was to establish whether the various liquid assets normally held by interest-based banks could be held by an Islamic bank.

K) Payment of Zakaat

*Question 22: Is Zakaat (compulsory charity) payable on a bank's profit?*

**Question 22**

The question was posed for the purpose of determining whether Zakaat (compulsory charity of 2,5 per cent of one's wealth) would have to be paid by an Islamic bank on its profits realised.

L) Support and suggestions for the successful operation of an Islamic bank in Tshwane and surrounding area.

*Question 23: Would you support an Islamic bank established in South Africa? Give reasons.*

*Question 24: What suggestions could you offer for the successful operation of an Islamic bank in South Africa?*

*Question 25: Any other comments?*

**Question 23-25**

This question was included in the interview in an attempt to establish whether the religious leaders would support an Islamic bank in Tshwane and what pertinent suggestions they could offer for the successful operation of such a bank.

## **5.4 SUMMARY**

In this chapter the sample design which specifies the population, the sample frame, the sample size and sampling procedure was discussed. The research methodology used involved a qualitative approach as it seemed to be the best option in securing the much-needed input, views and experiences from the various members of the population studied. The following groups of people were interviewed: Muslim business people, Islamic bankers and religious leaders of Islam. Their views, put together with the findings of the literature review, play a pivotal role in the construction of a simple model for the establishing of an Islamic banking enterprise within the South African economic environment.

In the next chapter the responses of the various categories of respondents will be tabulated, analysed and interpreted.

## **CHAPTER 6: ANALYSIS AND INTERPRETATION OF RESULTS**

### **6.1 INTRODUCTION**

The previous chapter was concerned with procedures that were employed in collecting data that related to the issues under research. In this regard matters such as the selection of data sources as well as the selection, preparation and the administration of the research methodology instruments used were covered. This chapter will deal with the responses given by the various categories of respondents which will be tabulated, analysed and interpreted. The chapter concludes with a summary of the major findings and trends which will then serve as a basis for the construction of a model for the establishment of an Islamic banking enterprise in Tshwane and its surrounding areas.

### **6.2 METHOD OF DATA ANALYSIS**

#### **6.2.1 Data collection**

As mentioned earlier the data collection was done by way of a structured interview that was based on a pre-planned questionnaire that was used to acquire the necessary information. The interviews were conducted with the various groups of respondents as identified in the sample selection. The views of the respondents were summarised in writing and entered in the prepared questionnaire. The data is qualitative in nature incorporating both nominal and ordinal variables. The data is qualitative since the questionnaire was designed to reveal a target audience's range of behaviour and the perceptions that drive it with reference to a specific topic such as Islamic banking or other related issues. The methodology used to solicit opinions, attitudes and feelings of respondents led to in-depth studies of small groups of people that would guide and support the construction of the hypotheses. The results of the qualitative research are descriptive rather than predictive.

### **6.2.2 Data analysis**

The data was analysed using a simple technique of addition and percentage determination in areas where it was deemed appropriate. Since most of the information obtained was of a qualitative type, it did not warrant extensive statistical analyses.

### **6.2.3 Method of analysis**

Statistical analysis of the data obtained was not conducted, this being due to the nature of the empirical study that was undertaken. The most crucial or pivotal aim of the analysis was to probe into the kind of responses that came from the various categories of respondents and then to summarise their responses. A statistical analysis of the data in the given circumstances would not be feasible bearing in mind the nature of the questionnaire. The purpose of the questionnaire was to obtain critical information, and not to analyse or find correlations amongst variables. Questions that were put forth during the interview were of the open- and close-ended type. In respect of the open-ended questions where a large volume of data was generated, the responses were categorised for the purpose of data analysis. Open-ended questions did not generate a large volume of data and it was decided not to categorise the data, but merely to discuss the range of attitudes expressed. As far as the close-ended questions were concerned, the analysis of the data was done on the basis of comparison of the frequencies of the responses.

## **6.3 ANALYSIS AND INTERPRETATION OF DATA**

This section will focus on the data collected from the structured interviews with the respondents and will attempt to offer some comment on and interpretation of the apparent pattern and trends that they reflect. Before going into the analysis and interpretation of the results it would be worthwhile to enumerate some of the

problems that surfaced during the conducting of the empirical study. These are summarised briefly below:

- Respondents were hesitant in some cases in providing certain kinds of information (which they possibly regarded as business or privileged information).
- Care had to be taken to ensure that the respondents were not being led towards a certain response with regard to answers furnished.
- As a result of the busy schedules of some respondents, particularly the business people, they were in a hurry to conclude the interview. It was also a challenge to keep them focused. Therefore time was an issue affecting the research. If there had been more time, some areas of the questionnaire could have been dealt with in greater depth.
- Problems were also encountered in documenting the results; hence care had to be taken to ensure that there was no bias towards any specific response. In this connection care had to be exercised against the rendition of one's own opinion or comment on views presented by the respondent.

The data will be analysed and interpreted in the following sequence: firstly the data of the Muslim business people, secondly the responses of the Islamic bankers and finally those of the Islamic religious leaders. In respect of the analysis of data dealt with in the interview a brief discussion of each question or group of questions follows the statistics and comments.

### **6.3.1 Interviews with the Muslim business people**

A) *Some basic questions related to the profile of Islamic business enterprises*

*Question 1: Is the business privately owned?*

*Question 2: Is the business managed by the owner?*

*Question 3: Is part of the capital supplied by the owner?*

*Question 4: If the answer is YES, what part of the capital is supplied by the owner?*

**Table 6.1: Ownership and supply of capital**

<b>OWNERSHIP AND CAPITAL</b>	<b>NUMBER</b>	<b>%</b>
Privately owned and owner- managed	20	100
Capital: Owner-supplied	15	75

Table 6.1 reveals that all of the business enterprises selected were privately owned and managed by the owners. The majority were the sole suppliers of capital whilst 5 (25%) confirmed that they supplied part of the capital themselves whilst the rest came as borrowed funds. Respondents were reluctant to go into detail as to the sources from which the borrowed funds were acquired; hence it was not possible to probe into this any further. It stands to reason that for the purpose of economic development money is needed – either an entrepreneur has funds available for this or else it must be borrowed. Commercial banks provide capital in the form of loans and advances; this is called bank credit and the price of such borrowed funds is called interest, which is against the edicts of Islam. However, if participatory financing is undertaken then both the financier who has the capital as well as the entrepreneur will tend to benefit: to those with capital it will offer an earning which would be legitimate within an Islamic framework, whilst to the entrepreneur it will open access to Riba-free income which may not otherwise be possible.

*Question 5: Indicate the nature of your business.*

**Table 6.2: Nature of business**

<b>BUSINESS TYPE</b>	<b>NUMBER</b>	<b>%</b>
Manufacturing	6	30
Import/Export	2	10
Service industry	2	10
Trade	10	50
<b>Total</b>	<b>20</b>	<b>100</b>

Table 6.2 illustrates that the biggest part of business comes from trade, while the import/export and service sectors are a clear minority. Thus the financial needs of these businesses would probably be more related to bridging finance rather than project finance.

*Question 6: How many people are employed by the business?*

**Table 6.3: Classification of responding business according to White Paper on National Strategy For Development and Promotion of Small Business in South Africa (1995)**

<b>CLASSIFICATION OF BUSINESS</b>	<b>ACCORDING TO NUMBER OF PERMANENT EMPLOYEES</b>	<b>ACTUAL NUMBER</b>	<b>%</b>
Small business	5 to 50 employees	15	75
Medium-sized business	51 to 200 employees	5	25
<b>Total</b>		<b>20</b>	<b>100</b>

Table 6.3 reflects the classification of responding businesses according to the White Paper in terms of the number of permanent employees employed by the business. The table illustrates that 15 (75%) of the businesses fell in the category of a small business whilst 5 (25%) fell in the category of a medium-sized

enterprise. It appears highly unlikely that these small businesses will engage in participatory financing since most of the businesses are family owned and passed over from generation to generation. Any outsider who wishes to come in as a partner would probably be viewed as an intruder. However, these entrepreneurs might use services of an Islamic bank other than financing, for which a fee has to be paid.

B) *Support of existing commercial banks*

*Question 7: At present are you using the facilities of the existing commercial banks; that is the current, savings or the fixed deposit account?*

**Table 6.4: Using facilities provided by the existing commercial banks**

<b>FACILITIES USED / NOT USED</b>	<b>NUMBER</b>	<b>%</b>
YES	20	100
NO	-	-
<b>TOTAL</b>	<b>20</b>	<b>100</b>

Table 6.4 reveals that all 20 (100%) of the Muslim business people are presently using facilities provided by existing commercial banks. This shows that the business people still have confidence in the facilities provided by the commercial banks although they are interest based. When asked the question some of the respondents were hesitant in furnishing a response, indicating that perhaps they felt guilty that by responding in the affirmative they would be guilty of un-Islamic conduct, but they responded nonetheless.

Question 8: Could you please rank the type of facility that you consider important and give reasons for selection?

*Current, savings, fixed deposit, other accounts under the following headings:*

*Very important, reasonably important, important, not important, completely unimportant*

**Table 6.5: Facility considered most important**

<b>FACILITIES MOST IMPORTANT</b>	<b>NUMBER</b>	<b>%</b>
Current account	20	100
Savings account	7	35
Fixed deposit	2	10
Other	-	-

Table 6.5 indicates that all business people interviewed consider the current account facility to be the most important for conducting their business affairs. Some of the reasons given for this were as follows:

- Overdraft facilities granted on current accounts enables their essential business commitments to function properly.
- Current accounts are indispensable for business people as such accounts facilitate easy payment, since payments to suppliers are normally made on a monthly basis and expenses on a weekly basis.

Considering that the majority of respondents are from the trade sector (see Table 6.2 above) it was to be expected that a current account facility is the preferred choice.

Seven (35%) of the respondents indicated that they also need savings account with commercial banks and considered this account to be reasonably important, whilst two (10%) of the respondents indicated that they considered the fixed deposit account to be important and that they also held fixed deposit accounts in their personal capacity. However, it needs to be noted that the respondents on their own accord mentioned that the earning of interest in no way influenced them to deposit in savings and fixed deposit account. The factor of saving for the future and security of their funds seemed to be the most dominant factor in investing in savings and fixed deposit accounts. In fact, four of the respondents mentioned that whatever interest they earned on deposits was given away towards charity, while three indicated that they gave the interest back to the bank.

C) *Interest within the context of the Islamic religion:*

*Question 9: Does Islam prohibit dealings in interest transactions?*

**Table 6.6: Interest within the context of the Islamic religion**

<b>PERMISSABLE</b>	<b>NUMBER</b>	<b>%</b>
YES	-	-
NO	20	100
<b>TOTAL</b>	<b>20</b>	<b>100</b>

Table 6.6 shows that all respondents are aware of the fact that Islam prohibits dealings in interest transactions and that participation in any Riba transaction would be unlawful from the Islamic perspective. The verses of the Quran proclaim the practice of usury, or making use of it, as major prohibited acts in Islam. Those who take it, those who pay it, its scribes and its witnesses are all regarded as guilty.

D) *Support for an Islamic bank*

*Question 10: Would you support an Islamic bank which provides all banking services and at the same time avoids any interest dealings?*

**Table 6.7: Support for an Islamic bank if same facilities are offered as interest-based banks**

<b>SUPPORT</b>	<b>NUMBER</b>	<b>%</b>
YES	20	100
NO		
<b>Total</b>	<b>20</b>	<b>100</b>

The data in Table 6.7 reveal that if an Islamic bank is capable of offering the very same facilities as the interest-based bank, then all 20 (100%) of the respondents would support such a bank.

*Question 11: What would you say be the main reason to keep funds in an Islamic bank? Tick the appropriate category:*

- Avoidance of interest*
- Offers good yield on capital*
- Dependable and trustworthy*
- Contributes to the welfare of Muslims*

**Table 6.8: Main reasons to keep funds in Islamic bank**

<b>REASONS</b>	<b>NUMBER</b>	<b>%</b>
Avoidance of interest	20	100

Offers good yield on capital	4	20
Dependable and trustworthy	5	25
Contributes to the welfare of Muslims	2	10

Table 6.8 reveals that all respondents agreed that avoidance of interest is the main reason to keep funds in an Islamic bank. However, four of the respondents indicated that apart from avoidance of interest another reason was being offered a good yield on capital or the possibility of the return being higher on funds invested in an Islamic bank as compared to interest-based banks. Five respondents (25%) also indicated the reason of such a bank being dependable and trustworthy, while one said: "I think it's nice as long as the people who are running the bank are truly honest and dedicated Muslims." The data in the above table indicates the avoidance of the interest factor and hence the conforming to Islamic principles as being the most important factor for keeping funds in the Islamic bank.

*Question 12: Would you support an Islamic bank operating on strict Islamic principles that does not offer any predetermined interest rate but allows you to share in the profit or loss on funds deposited with them? Give reasons.*

**Table 6.9: Support for an Islamic bank that complies with Islamic principles and allows one to share in the profit or loss on funds**

<b>SUPPORT ISLAMIC BANK: SHARE IN PROFIT OR LOSS</b>	<b>NUMBER</b>	<b>%</b>
YES	18	90
NO	2	10
<b>TOTAL</b>	<b>20</b>	<b>100</b>

Table 6.9 illustrates that 18 (90%) of the respondents state that they would support an Islamic bank that operated on strict Islamic principles that did not offer any predetermined interest but would enable them to share in the profit or loss on funds deposited with them. Two (10%) of the respondents, however, indicated that they would not invest their funds in an Islamic bank on a profit and loss sharing basis merely for the reason that it assumed the name Islamic. According to these respondents, only when they would be satisfied that those who are managing the Islamic bank are truly abiding by Islamic principles in their own private lives would they invest their funds in the Islamic bank. This shows that these particular individuals are not against supporting an Islamic bank, but would like to see true and honest people managing their funds. Some comments offered as reasons for entering into profit and loss on funds invested with an Islamic bank are as follows:

- Interest based banks have a tendency to use funds of depositors in certain investment projects yielding high profits. The bulk of the profits generated are then kept by the banks whilst a small amount is given to the depositors in the form of interest. Therefore these respondents are of the opinion that if depositors were allowed to share in the profits then there would be a just and equitable distribution of profits between banks and depositors. Hence, the possibility of realising a higher return on funds invested as compared to the fixed interest rates offered by banks was attractive to them.
- One definitive advantage of Islamic investment would be a reduction in the cost of production, because the cost will be free of interest. The manufacturer will have a better chance of making a profit since his prices will be lower than those of his competitors. Everybody benefits in such a scenario: the money supplier in terms of higher profits, the consumer in terms of lower prices and the manufacturer in terms of higher profits.

- According to Islam, Allah has permitted trade and made interest unlawful. This is regarded as Allah’s design. If interest-based dealings can be avoided by opening profit and loss sharing accounts, respondents would definitely prefer them.
- By investing funds on a profit and loss basis with an Islamic bank, it would make depositors feel like they have a stake in them, unlike the interest-based institutions where individuals merely receive interest, irrespective of what goes on in the organisation.
- The possibility of earning a higher return on funds invested as compared to receiving a fixed, predetermined rate of interest was seen as attractive.

The above views clearly indicate that there could be two groups of respondents who are favourably inclined to supporting an Islamic bank. One group could be classified as Islam-inclined investors, whilst the other could be classified as risk-taking investors. Both show keenness in supporting the Islamic bank but they appear to be governed by different motives.

E) *Other services provided by an Islamic bank and paying a fee for such service*

*Question 13: Would you also avail yourself of other services provided by the Islamic bank, e.g. safe custody of valuables, purchase and sale of foreign currency?*

**Table 6.10: Other services provided by the Islamic bank**

<b>OTHER SERVICES</b>	<b>NUMBER</b>	<b>%</b>
YES	20	100

NO	-	-
<b>TOTAL</b>	<b>20</b>	<b>100</b>

In response to these questions all respondents (100%) indicated that they would also avail themselves of the other services provided by an Islamic bank. They also had no objections to paying a fee for such services rendered. In fact, one of the respondents remarked: "I do pay a fee to the interest-based bank for such a service, then why shouldn't I pay to the Islamic bank?" From the above information it can be concluded that any other services provided by the bank would be used and no objection would be raised in paying for such services.

*Question 14: Would you have any objection to paying a fee for such service?*

None of the respondents had any objection to paying a fee for such services.

F) *Support for an interest-based bank apart from the Islamic bank*

*Question 15: Would you also support an interest-based bank apart from the Islamic bank? Give reasons.*

**Table 6.11: Support for an interest-based bank apart from the Islamic bank**

<b>SUPPORT BOTH ISLAMIC AND INTEREST-BASED BANK</b>	<b>NUMBER</b>	<b>%</b>
YES	4	20
NO	16	80
<b>TOTAL</b>	<b>20</b>	<b>100</b>

Table 6.11 indicates that 16 out of 20 business people (80%) interviewed

indicated that they would not support interest-based banks if an Islamic bank could adequately provide them with contemporary bank services.

Nevertheless 4 interviewees (20%) indicated that in tough economic times the possibility does exist that loans may be difficult to obtain from an Islamic bank. In such circumstances they as business people would have no option but to make use of the facilities provided by the interest-based banks. The above data show that Islamic banks should adequately meet the needs of their clients, in other words, they should be just as efficient as the interest-based banks if they wish to gain the full support of their clients.

*Question 16: Do you agree with the statement “Interest-based banking depositors are concerned only with a fixed return on their savings without much concern for the total operational results of banks”? Furnish reasons.*

This type of question concerning support for a statement may appear out of context, but is considered to be important as it made it possible to establish whether or not the respondents shared the stated opinion.

**Table 6.12: Agreement with the statement that interest-based depositors are only concerned with a fixed return on savings without much concern for the total operational results of a bank**

<b>STATEMENT 16</b>	<b>NUMBER</b>	<b>%</b>
YES	20	100
NO	-	-
<b>TOTAL</b>	<b>20</b>	<b>100</b>

Table 6.12 shows that all the business people interviewed responded in the

affirmative with respect to statement 16. Some comments offered in response to this statement were the following:

- Interest-based banks lose out on certain ventures as a result of mismanagement of funds. However, the depositors cannot be bothered about that as they are receiving their fixed returns.
- The performance of these banks is not monitored by the depositors and hence resources may not be utilised efficiently.

*Question 17: Would you agree with the statement that “Under Islamic banking the operational results of the banks will be of great concern to depositors since they share in the profit or loss”? Furnish reasons.*

**Table 6.13: Agreement with the statement that under Islamic banking the operational results of the banks are of great concern to depositors**

STATEMENT 17	NUMBER	%
YES	20	100
NO	-	-
<b>TOTAL</b>	<b>20</b>	<b>100</b>

Table 6.13 also illustrates that all of the business people interviewed responded in the affirmative with respect to statement 17. Some of the comments offered in response to this statement were:

- Islamic banking will focus on merit because it will distinguish good performance from poor and mediocre performance.
- Islamic banks will use their resources in the most efficient manner.

The above views do indicate that the performance and entrepreneurial skills of the banks will come under close scrutiny when depositors share in the profits of

the bank. Furthermore, comparisons to other similar lines of business could easily be drawn in the light of profits earned and distributed. Finally, with Islamic banking profits will act as a built-in incentive, thus leading to improved performance.

The following section deals with the bank financing transactions relating to any un-Islamic activities

*Question 18: Will it matter if such a bank finances transactions relating to any un-Islamic activities? Give reasons.*

All 20 respondents indicated that they objected strongly to the bank financing any un-Islamic activity. Some of the comments made by the respondents were as follows:

- This is an Islamic bank, then how can it finance any un-Islamic activity?
- I would immediately withdraw all my funds from the bank if it were to finance any un-Islamic activity.
- An Islamic bank should project the Islamic way of life and shun all activities which are against Islamic principles.

From the above data and comments made by the individuals it may be concluded that Islamic Banks must avoid dealing in any un-Islamic activity if they wish to secure the confidence of their clients.

G) *Operations of an Islamic bank checked by a religious supervisory board*

*Question 19: Would you prefer to have all the operations of the Islamic bank checked by a Religious Supervisory Board to ensure strict and continuous adherence to the Sharia? Give reasons*

In respect of this question all 20 respondents indicated that they would prefer to have all the operations of an Islamic bank checked by a religious supervisory board. The respondents emphasised the need to have individuals who are well qualified in Islamic economics, law and the Sharia to serve on such a board. Some of the comments made by the respondents were the following:

- People appointed to serve on such a board should be a selected group of individuals well qualified in Islamic law and jurisprudence.
- Those who serve on the board should have the final say with regard to the legality of the transactions that such an Islamic bank might enter into. The directors or other influential people should in no way dictate terms with regard to the legality of the transactions.

It may therefore be concluded that it is imperative that an Islamic banking enterprise appoints a religious supervisory board made up of well-qualified individuals who monitor all transactions of the bank in terms of its compliance to Islamic law.

H) *Establishment of an Islamic bank as a breakthrough for the Muslim community*

*Question 20: Do you consider the establishment of an Islamic bank in South Africa as a breakthrough for the Muslim community? Give reasons*

**Table 6.14: Establishment of an Islamic bank as a breakthrough for the Muslim community**

<b>AN ISLAMIC BANK AS A BREAKTHROUGH</b>	<b>NUMBER</b>	<b>%</b>
YES	18	90
NO	2	10
<b>Total</b>	<b>20</b>	<b>100</b>

The majority of the respondents (18, or 90%) indicated that they considered the establishment of an Islamic bank as a breakthrough for the entire Muslim community. Some of the responses indicated below illustrate the importance that these respondents attach to the establishment of an Islamic bank:

- An Islamic bank would unchain the Muslim community from the curse and miseries of interest and would pave the way for them to play their natural role in which their welfare and prosperity lie as commanded by Allah.
- The establishment of such a bank would reflect the sincere desire of South African Muslims to follow the Islamic way of life.
- The most important thing today is that as Muslims we are supposed to live all aspects of our lives according to Islam. Therefore the establishment of an Islamic bank will enable Muslims to invest their funds according to Islamic precepts, free of interest which is prohibited by the Sharia.
- The establishment of an Islamic banking enterprise could be regarded as a vehicle propagating Islamic consciousness.

However, two individuals (10%) indicated that they did not consider the establishment of such a bank as a breakthrough unless it proved itself. Their comments were:

- We are jumping the gun here; we cannot call it a breakthrough for that will depend on the condition whether those people controlling the funds of the bank are conforming strictly to Islamic principles themselves.
- Only if the bank, by way of its investing of funds, is creating employment for the people.

- It depends on whether the bank will be attempting to raise the welfare of the poor in society and whether it will give preferential treatment only to the wealthy.

If may be concluded that the establishment of an Islamic bank may be seen as a breakthrough for the Muslim community only if the bank performs its function strictly according to Islamic principles and raises the welfare of the poor in the community.

l) *Suggestions with a view to attracting funds*

*Question 21: Are there any suggestions that you could offer to Islamic bankers with a view to attracting funds?*

Some of the suggestions rendered by the business people to Islamic bankers with a view to attracting funds are mentioned below:

- Islamic bankers need to win the confidence of all sections of the community by pointing out to them that they are concerned with the welfare of the people. This could be shown by providing low-cost housing for people in the low-income groups.
- Islamic bankers should come to the rescue of those people who have the skills and expertise for business but lack funds. They should provide them with interest-free loans and set them up in life.
- There is a great need to inform members of both the Muslim and non-Muslim community as to the operational mechanics of an Islamic bank. They can do this by heavily advertising their products in newspapers and glossy magazines and on TV and radio.

- An attempt should be made to attract overseas investors, especially in the countries of the Middle East.
- Quarterly reports should be published, showing progress of the Islamic bank especially as regards profitability and investment portfolios.
- Funds can be raised from the sale of Islamic artefacts donated to the bank, such as old Islamic frames or valuable editions of the Quran.
- The bank must be able to offer good package deals, like a Hajj/Umrah savings scheme. This refers to assisting people in saving for the pilgrimage to the Holy Land of Mecca and Medina at least once in their lifetime. Moreover, social security schemes such as pension funds, medical aid schemes and Islamic insurance products need to be developed to cater for the needs of the Ummah.
- Islamic bankers will have to focus on those avenues of investment which will generate maximum profit. High profits realised will be the greatest inducement factor for attracting more funds.
- Islamic banks thus frankly must be capable not only of providing contemporary banking services so as to attract funds, but they must also prove themselves to be just as efficient as the interest-based banks and at the same time operate within Sharia principles.

### **6.3.2 Interviews with Islamic bankers**

The information that was obtained from the Islamic bankers is summarised below.

#### **A) *Objectives of an Islamic bank***

*Question 1: Name of bank or institution?*

*Question 2: When was the bank founded?*

*Question 3: What would you say is the main objective that influenced the bank to become Islamic? Tick the appropriate box:*

- Economic*
- Ethical and/or justice*
- Religious*
- Political*

*Question 4: Briefly explain how do you intend to realise your objectives?*

The Al Baraka Bank was founded in 1989 and it was quite clear from the information revealed that its bankers wished to put before all Muslims a novel, integrated, economically and financially viable banking system in which all services and procedures were compatible with Islamic Sharia. These individuals intended to realise their objectives by providing non-usurious banking operations.

#### *B. Operational mechanisms*

*Question 5: Would you please try to rank the account types that may have been constituting the major liabilities of a bank?*

*Demand deposit, time deposit, investment deposit and other deposits under the following categories:*

*Very important, reasonably important, important, not important, completely unimportant.*

It was quite evident from the information received that the major liabilities of the bank consist of investment deposits, followed by savings deposits, whilst demand deposits ranked last. Another liability which has recently gained prominence is

the future growth Al Baraka Equity Fund; a convenient Islamic investment option.

C) *Clients of the bank*

*Question 6: Is the bank only open to members of the Muslim community? If the answer is NO, then are there any non-Muslims who are clients of the bank?*

The responses indicated that the bank is open to members of both the Muslim and non-Muslim community, and that there are also non-Muslim employees at the bank.

D) *Depositors entering into profit and loss sharing agreement*

*Question 7: Are depositors required to enter into a profit and loss sharing agreement with the bank?*

Depositors will enter into a profit and loss sharing agreement in respect of those deposits made in the profit and loss sharing accounts, investment accounts or participating accounts. The depositors who deposit their funds in this account will authorise the bank to use their money at its discretion to finance profit-yielding projects. From the total profits realised, the bank takes a certain percentage of the profits; about sixty per cent is returned to depositors and forty per cent to the bank.

E) *Finance techniques*

*Question 8: Please rank the following financing techniques that are appropriate to your bank:*

*Mudarabah, Musharaka, Murabaha, Ijara, Qard-ul-Hasna*

*under the following categories:*

- *Very important*
- *Important*
- *Less important*
- *Not important*

The bankers agreed that they make use of these financing techniques, ranking Mudarabah (trust funding), Musharaka (equity participation) and Murabaha (mark-up) as very important, whilst Ijara (leasing) and Qard-ul-Hasna (interest-free loan) were ranked as important. Each one of these is briefly reviewed below.

1. Mudarabah (trust funding)

In this case the bank provides the capital and the entrepreneur contributes his skill, effort and enterprise. Profits are shared according to some predetermined ratio.

2. Musharaka (equity participation)

An agreement is entered into between the bank and the entrepreneur whereby each party provides a portion of the capital requirement. Profit and losses are shared on a pro rata basis.

3. Murabaha (mark-up)

In this construction a contract between the bank and the client is entered into whereby the bank purchases certain equipment or goods for its clients and resells these to the client on a deferred payment basis at cost plus a profit mark-up. The mark-up is applied in a transaction relating to an asset and not to a loan. An increase in a loan transaction would be construed as interest; however, a fixed or predetermined increase in a sale transaction of an asset or commodity is not regarded as interest. In this kind of transaction the purchaser expresses his desire to make payment on a

deferred basis and the price quoted by the seller is accepted by the buyer. In such a case it is considered as permissible as the sale falls within the Quranic definition of “trade by mutual consent”. The risk is borne by the seller until the buyer fulfils his promise to buy.

4. Ijara (leasing)

The bank purchases certain equipment, property or facilities as requested by the client against an agreed rental payment.

5. Qard-ul-Hasna (interest-free loan)

This kind of loan is offered to those who badly need it; it is totally free of interest.

F) *Overdraft facilities*

*Question 9: Does the Islamic bank grant overdraft facilities? If YES, on what basis?*

The data revealed that the bankers do not grant any overdraft facility.

G) *Discounting of Bills of Exchange and other banking services*

*Question 10: Does the Islamic bank discount Bills of Exchange? If YES, then on what basis? Explain.*

*Question 11: Does the bank provide other banking services to its clients?*

*Question 12: Is a fee charged for this service?*

In connection with the discounting of Bills of Exchange the bankers indicated that

they will not discount such bills. Bankers agreed that the bank provides other banking services such as the purchase and sale of foreign currency, letters of credit, consultancy services, etc. The bank charges a fee for these other banking services.

H) *Financial instruments for disbursements of its short term funds*

*Question 13: The Islamic bank depends for a substantial proportion of its resources on short-term and liquid funds. Therefore it requires short-term instruments for realisation as well as disbursements of its short-term funds. For an interest-based bank these instruments are to be found in interbank operations, Treasury Bills, Government Bonds, and in various money market operations such as bankers' acceptance, Government Bonds and bill discounting. However, these to a great extent are interest based and therefore not normally available to an Islamic bank, there is then this gap in the operation of the Islamic bank. How do you intend bridging this gap? Briefly explain.*

During the course of the discussion it emerged that the Islamic bank is operating in the phase of what may be termed as an experimental stage of their development. Short-term instruments like Treasury Bills, Government Bonds and bankers' acceptance, which are normally available to banks, are not held by the Islamic bank since these instruments are interest based. However, information from the bankers reveal that they are attempting to bridge this gap in the bank's operation via the introduction of the 35-days participation account and through public funding by way of deposits and the selling of shares in the company. The bankers also indicated that other avenues for short-term investment are under study. It therefore follows that there is a pressing need on the part of Islamic banks to devise suitable Islamic financial instruments if savings are to be fully

mobilised for financing investment.

I) *Banking controls*

*Question 14: Is the Islamic bank subjected to the same banking controls as applicable to the interest-based bank? If YES, then how will the bank comply with the liquid asset requirement? Explain.*

It is evident from the discussion that ensued and the feedback received that the Islamic bank is subjected to the same banking controls as applicable to the interest-based banks. It will observe all the ratios prescribed by the Reserve Bank in respect of cash reserves and liquid assets so as to meet its obligation towards the depositors' demand for withdrawal. However, the bank will only hold such liquid assets that are not interest bearing; hence there is a pressing need to find suitable Islamic financial assets that are devoid of the interest factor. Some research in this direction is presently being done, for instance the idea of having Islamic bonds or Sukuk giving investors a participative right in the underlying assets.

J) *Payment of Zakaat*

*Question 15: How is the bank's annual payment of Zakaat (compulsory charity) paid? Explain.*

*Question 16: Is such a payment tax-deductible?*

The view of the bankers was that the responsibility for paying Zakaat was that of the depositors who should assess their own assets and liabilities and pay their own Zakaat. The bank itself will only accept Zakaat from parties who deputise the bank to pay Zakaat from their money on their behalf. Such payment is not tax-deductible unless the payment is made to a registered charitable organisation.

K) *Types of investment*

*Question 17: What kind of projects do you mainly support financially?*

The projects that are supported by the banks are diverse in nature, and those that are particularly appraised are those that will promote the well-being of people through economic and social development and the enlargement of opportunities for gainful employment. However, all such projects would have to be Sharia compliant.

K) *Management and staffing*

*Question 18: Is the bank managed in the same manner as a joint stock company, in general by a board of directors elected in accordance with its articles of association?*

*Question 19: How is the Islamic bank staffed as regards any special categories of employees? Explain.*

*Question 20: Does the bank employ specialist personnel from the non-Muslim community? If YES explain.*

The discussion revealed that the bank is managed by a board of directors appointed by the shareholders. In respect of personnel all staff members are supposed to be suitably qualified in Sharia (Islamic law). It is seen as advantageous if staff have banking experience; however, the bank does employ staff who have specialised knowledge in management, accounting and finance. It also emerged from the discussion that the bank does employ specialist personnel from the non-Muslim community as long as they have the special skills required by the bank.

M) *Legal consultant*

*Question 21: Does the bank appoint an Islamic legal consultant?*

*Question 22: Does he possess any specific qualification?*

The feedback received from the respondents indicated that the bank has in its employ an Islamic legal consultant who is a theologian and also has some special qualification in Islamic economics and banking.

N) *Reaction of South African banking authorities*

*Question 23: What has been the response of the South African banking authorities to the establishment of an Islamic bank in South Africa?*

The South African banking authorities are very receptive especially with regards to the challenges facing the Islamic bank and are very supportive towards the undertaking of research, especially with regards to the impact of the Basel accords on Islamic banking.

At first the entry of an Islamic bank into the market place appeared to raise a degree of opposition from the established banks, but now their outlook is much more favourable and it is envisaged that some degree of cooperation between the banks will be established in the future.

O) *Major problems of the Islamic bank in South Africa*

*Question 24: What major problems are you confronted with in opening an Islamic bank in South Africa? Explain.*

*Question 25: In your opinion, how can these problems be resolved?*

Some of the problems of Islamic banks in South Africa as enunciated by the respondents are listed below:

- To build up investor confidence
- Ignorance of the operational mechanics of Islamic banking
- Comparison by the Muslim community of the established conventional banks with the Islamic bank
- Finding adequately trained personnel
- To devise new short-term financial instruments that are not interest based for the mobilising and disbursing of funds
- To attain the same level of efficiency as conventional banks

The respondents also highlighted some of the ways in which the problems could be resolved. These are listed below:

- Educating the public on the operational mechanics of Islamic banks
- Train and teach local employees
- Greater degree of research in areas of Islamic banking required
- Islamic banks require greater exposure

P) *Priorities for the future*

*Question 26: What are your priorities for the future?*

As regards the priorities for the future, the respondents' comments are furnished below:

- To open more branches throughout South Africa

- To provide current account, credit/debit cards, and foreign exchange facilities
- To establish a sound and successful Islamic bank with product offerings which are Sharia compliant
- To serve the needs of the broader community
- 

### **6.3.3 Issues arising from interviews with religious leaders**

A) *Religious leaders views on interest*

*Question 1: What is the Islamic viewpoint on the receiving and paying of interest?*

*Question 2: Are the present conventional bank interest based?*

*Question 3: Does Islam consider it an act of sin, if one continues dealing on the basis of interest knowing it as being unlawful?*

*Question 4: Would it be considered an un-Islamic act where a Muslim businessman in South Africa conducts some of his business with an interest-based bank?*

*Question 5: If renting of money at a price is termed interest (Riba) why then is the renting of property at a price permissible?*

The responses to the questions and the discussions that ensued in relation to the foregoing issues revealed that the receiving and paying of interest is regarded as unlawful from an Islamic viewpoint. The present banks in South Africa are all interest based and supporting such banks despite knowing that its practice is unlawful is considered an act of sin for Muslims. If Muslims have no option but to

deal with such banks it is suggested that the individual Muslim restricts his dealings to his most urgent needs only. It also became clear from the interviewees' response that for an individual Muslim the renting of property is permissible in Islam as it forms part of trade, whilst renting of money at a price amounts to interest and is considered unlawful.

B) *Views on hoarding money*

*Question 6: Does Islam permit the hoarding of money (holding back money from circulation)?*

It was quite evident from the discussion that the hoarding of money is not permissible in Islam.

C) *Views on trade*

*Question 7: Does Islam permit trade?*

*Question 8: Would I be correct in saying that the earning of money through trade is permissible whilst earning through the lending of money at a price is forbidden?*

*Question 9: How did Prophet Muhammad (S.A.W) view trade? Please elaborate.*

The respondents agreed that Islam permitted trade and forbade money to be lent at a price, known as Riba (interest). It became quite clear from the respondents' responses that if renting of money at a price known as interest was unlawful and the hoarding of money as well, then there remained only two other options open that would be acceptable from an Islamic viewpoint, namely that of lending

money free without a price and that of money invested into business with the intention of engaging in lawful trade for the purposes of realising a profit. Also the feedback received clearly indicated that Prophet Muhammad (PBUH) recognised trade as a form of worship and regarded it as mandatory for believers to engage in lawful trade.

D) *Views on profit and loss sharing*

*Question 10: Is it permissible for people with surplus money to entrust their funds to those who have skills and experience for utilising it for productive purposes?*

*Question 11: If YES, then would it be lawful for the suppliers of capital to share in the profit with the users of capital?*

*Question 12: Was this practised by the Holy Prophet Muhammad (S.A.W) during his lifetime? Please elaborate.*

*Question 13: In the event of there being a loss how should this be apportioned between the parties? Elaborate.*

From the discussion that ensued it was quite clear that it was considered permissible for people with surplus money to entrust their funds to those who had the skills and experience for utilising it for productive purposes and that it was lawful for suppliers of capital to share in the profit with the users of capital. However, the religious leaders were not in a position to say whether such form of business was practised or not by the Prophet Muhammad (PBUH). As regards the apportionment of loss the religious leaders agreed that losses were to be borne by the capital contributor unless the loss was due to negligence or misconduct on the part of the entrepreneur.

E) *Mudarabah as a form of business financing*

*Question 14: The Islamic term used for this form of business financing is Mudarabah. Do you agree?*

*Question 15: Beside this mode of financing, is it acceptable to devise other modes which avoid any interest dealing but permit trade?*

The religious leaders agreed that the Islamic term given to this form of business arrangement mentioned earlier on was Mudarabah. It also became evident from the discussion that devising other modes of financing which avoid any interest dealings but permit trade would be acceptable in Islam.

F) *Basis of an Islamic banking model*

*Question 16: Do you agree that in respect of banking, a trade-based model of banking would be a plausible alternative to the interest-based model?*

*Question 17: The establishment of an Islamic bank on the Mudarabah basis is acceptable. Do you agree?*

It became clear during the course of the interview that Islam would approve of a trade-based Islamic banking model established on a profit and loss sharing basis.

G. *Various other modes of financing*

*Question 18: Are the following modes of financing by Islamic banks lawful?*

- (a) *The financing by lending (without interest or cost of funds) on which banks may recover actual service charges from time to time.*
- (b) *The purchasing of goods by banks and their subsequent sale to clients at an appropriate mark-up price on a deferred payment basis (Murabaha).*
- (c) *The leasing/renting of assets where the financing bank acquires equipment or buildings and rents them to the user against a fixed charge (Ijara).*
- (d) *The equipment/buildings are bought by the financier for the user and rented out to him. The user agrees to deposit certain sums over an agreed period into an investment account with the bank. These sums are reinvested for the purchase of the items at an agreed price (Ijara wa Iqtina).*
- (e) *One party invests capital which the other party uses for trade or investment. The profits are shared according to an agreed ratio. The losses are however deducted from the capital (Mudarabah).*
- (f) *Funds are provided as equity or working capital or both and any profit or loss is shared according to an agreed ratio (Musharaka).*
- (g) *Financing by lending without interest and without service charge (Qard-al-Hasna).*

All modes of financing techniques mentioned were considered lawful; however, one of the respondents did mention that in respect to financing by lending the actual service charges may be recovered, but these should be market related and not constitute interest in the guise of a service charge. Also in respect of the Murabaha financing technique, the same respondent commented that the bank must take physical or constructive risk and bear this risk, even though it might be for a short duration.

H) *Other services*

*Question 19: An Islamic bank that provides service for a fee, e.g. purchase and sale of foreign currency or safe custody of documents, is possible.*

Discussion on this topic revealed that an Islamic bank would be justified in charging a fee for any other services that it may render.

I) *Religious Supervisory Board*

*Question 20: Do you feel it necessary that the Islamic bank appoints a Religious Supervisory Board to ensure all transactions adhere to strict compliance to Islamic Sharia? If YES, what in your opinion should be the qualification and main functions of such a board? Please elaborate.*

The discussion revealed the need to appoint a religious supervisory board in order to ensure strict and continuous adherence to Islamic Sharia. It also became evident that such a board should be conversant with Islamic economic law.

J) *Legality of the various liquid assets*

*Question 21: Are the following liquid asset dealings used by the conventional banks interest based?*

- *Treasury Bills*
- *Land Bank Bills*
- *Reserve Bank Debentures*
- *Negotiable Certificate deposits*
- *Bankers' acceptance*
- *Municipal stocks*
- *Government stocks*

During the interview with the respondents it emerged that the liquid assets normally held by the traditional interest-based banks could not be made available to the Islamic bank as the instruments were all interest-based.

K) *Payment of Zakaat*

*Question 22: Is Zakaat (compulsory charity) payable on a bank's profit?*

All respondents did agree that Zakaat (a compulsory annual charity of 2,5% of one's wealth) has to be paid on a bank's profit.

L) *Support and suggestions for the successful operation of an Islamic bank in the Tshwane and surrounding areas.*

*Question 23: Would you support an Islamic bank established in South Africa? Give reasons.*

*Question 24: What suggestions could you offer for the successful operation of an Islamic bank in South Africa?*

*Question 25: Any other comments?*

The responses indicated that the religious leaders would definitely support the establishment of an Islamic bank, as long as there would be compliance with Islamic Sharia. Some suggestions offered for the successful operation of an Islamic bank were the following:

- An Islamic bank would need more stringent monitoring processes including appointing internal Sharia experts.

- It should be run strictly on Islamic principles with the object of serving the needs of the Muslim community and promoting the spirit of Islam.
- It should not be run like any other business enterprise where the only motive is to increase monetary gain.
- Participants in such banks should be fully aware of the objectives of the banks and they would be encouraged to project the Islamic way of life in their business.

#### **6.4 SUMMARY**

In the preceding sections of this chapter an attempt has been made to bring some order to the range of information provided by the respondents in their answers to the open- and close-ended questions during the interviews. Without offering any detailed comment on the profile it is perhaps necessary to summarise a few of the significant conclusions that emerged.

As far as the Muslim business people were concerned it would seem that the majority were in favour of an Islamic bank primarily because of the avoidance of interest factor, although a small number would also support this on the expectation of a high return on investment. The responses of the Muslim business people also indicated that the current account type with cheque facilities was the most important to them in their business dealings. Also efficiency in the provision of banking services seemed to be an important factor in determining whether support would be accorded to an Islamic bank or not.

What has become clear from the interviews with the Islamic bankers is their strong adherence to Islamic Sharia principles and the need to train more personnel in the field of Islamic economics, jurisprudence and banking. A major problem revealed through the interviews with the Islamic bankers is the unavailability of the conventional short-term monetary instruments. Another

related issue that seems to emerge is that monetary policy would lose a considerable degree of flexibility since open-market operations involving the use of government bonds or treasury bills would be nullified.

The responses from the religious leaders as regards the establishment of an Islamic bank can be summarised as a determined effort on the part of the Islamic community to break away from what is regarded as the curse and unlawfulness of interest. The establishment of an Islamic bank is seen as paving the way for them to play their natural role in which their welfare and prosperity lie as commanded by the Almighty God. Also the Islamic bank will enable the Muslim community to lead their life in accordance with the edicts of Islamic Sharia which is of pivotal importance to them within the context of Islam. Hence the Islamic bank will enable Muslims to invest their funds according to Islamic precepts, of which the most important is that transactions should be free of interest which is prohibited by Islamic law.

In the next chapter an attempt is made to construct a model for the establishment and long-term survival of an Islamic bank in the Tshwane and surrounding areas on the basis of the findings of the literature study and research conducted.

## CHAPTER 7: CONSTRUCTION OF A MODEL

### 7.1 INTRODUCTION

Using the notions of Islamic banking presupposes that another type of banking exists which is not Islamic. This non-Islamic form of banking has been in existence for a very long time and it is based on the application of interest-based techniques. Islam, however, is opposed to this form of banking because Allah in the Holy Quran has prohibited interest-based dealings but has permitted trade (or Bai). The implication of this is that an increase in money earned through lending of capital at a price (interest) is forbidden whilst an increase earned through trade is sanctioned.

It therefore follows that the means adopted for earning money are considered important from an Islamic perspective. This unconditional divine instruction together with other stern warnings appearing in certain verses of the Quran forbidding Muslims to deal in interest lends urgency to the quest to find an alternative to the existing interest-based banking system. It therefore stands to reason that any alternative model which is designed should be in accordance with Islamic law, since Muslims regard this as Allah's design. Since trade is preferred by Allah, a trade-based model of an Islamic bank would be the best alternative to conventional banking systems. Islam permits transactions based on the profit and loss sharing principle or on the basis of Mudarabah. Mudarabah is simply a contract between two parties where one party supplies capital but takes no active part in the enterprise that is run by the other party, who has invested no capital. The entrepreneur agrees to surrender a specified part of the profits of the enterprise to the owner of the capital who takes the entire responsibility for any losses that might ensue. In the case of a loss the entrepreneur goes unrewarded for his entrepreneurial services rendered whereas in the case of profit made he is rewarded by a share therein.

Based on the literature study and empirical research that was undertaken, an attempt is made in this chapter to construct a simple model for the establishment and long-term survival of an Islamic bank in the greater Tshwane area, based on the profit and loss sharing system. The model will look into two options, one which could possibly be based on the adoption of a metallic currency and another that could be based on fiat money, which is money that has little commodity value compared to its value in exchange. This money is issued by government, the central bank and other financial institutions.

The metallic currency system envisaged would be the gold and silver coin system or the gold dinar and silver dirham respectively which would be represented by actual money containing a certain weight of gold and silver, each dinar having a fixed weight of 4,25 grams of pure 24 carat gold and each dirham having a fixed weight of 3 grams of ,9999 silver. Gold and silver are the most stable currencies that the world has ever seen. From the early days of Islam till today the value of the Islamic bimetallic currency has remained surprisingly stable in relation to that of basic consumable goods. According to Vadillo (2012:2) gold and silver, unlike paper currencies, do not depend on a third party's promise to pay. They have a value of their own as commodities and like all other commodities they have an intrinsic value prior to their value as a currency. It is therefore important to understand that a gold coin will always be valuable even if it has only a small number of monetary users. It needs to be mentioned that the creation of a unifying paper currency is a difficult task, since to become operational it will be faced with the mammoth task of competing against the United States dollar. It is only the Islamic gold dollar that has the ability to compete successfully against the US dollar irrespective of the initial number of users.

Whilst it may be accepted that changing to a metallic currency does not seem feasible and practical in modern financial markets, such a system could probably have prevented many an economic crisis as discussed in section 7.4 below.

## 7.2 CHANGE OF BANKING LEGISLATION

The first prerequisite for the survival of an Islamic bank in the greater Tshwane areas and within the South African economic environment at large would be a revision of existing legislation. Laws would have to be changed in such a way that a natural path for a trade-based banking model is clearly demarcated. Small and ineffectual changes in legislation will not suffice for the long-term survival of an Islamic bank, for only a well-integrated legal framework will produce an environment conducive to the survival of an Islamic bank in South Africa. If no supportive legislation is enacted in this regard then there will be no alternative but to support the interest-based bank system.

The Banks Act 94 of 1990 will have to be amended in a manner that will provide for the easy entry and functioning of an Islamic bank, for example, provision has to be made so that the following will be allowed:

- Islamic banks may accept deposits on a profit and loss sharing or participative basis. Section 1 of the Banks Act in brief defines a bank as a public company or a person whose main business entails the accepting of deposits from the general public in whatever form, and lending such funds to the public falls within the spheres of the business of banking. This section therefore does not allow for or permit the operation of an Islamic bank.

The section could however be amended to include the provision that *profit and loss sharing on the basis of Islamic Sharia principles be applicable business of banks in South Africa*. It could provide further that *at least fifteen per cent of deposits of such an Islamic bank be extended as non-compensating loans to finance social projects*.

The amended act would also allow conventional banks to open Sharia-based financial services.

- An Islamic bank should be allowed to accept deposits free of interest to ensure that it will not engage in any interest-bearing transactions; hence it should be permissible for an Islamic bank not to hold interest-bearing instruments such as treasury bills, debentures and government bonds. This would be necessary since banks are currently required to hold sufficient liquid assets in the prescribed ratios to ensure that they have an adequate liquidity “cushion” to fall back upon in the event of an abnormal withdrawal of cash by depositors. These liquid assets, such as treasury bills, debentures and government bonds are interest based and as such cannot be held by an Islamic bank. There is therefore an urgent need for short-term money market investment tools for liquidity management that are Sharia compliant.

Section 12(1) of the Banks Act provides that any person who intends carrying on the business of a banking institution has to apply to the Registrar of Banks for permission to establish a bank. In terms of Section 11(2) of the Banks Act any organisation that conducts the business of a bank without registration would be guilty of an offence. An Islamic bank would therefore not be in a position to conduct the business of a bank if it is not registered as a bank and in this regard the Registrar in terms of Section 13(2) may grant permission if he is satisfied that the applicant will be able to successfully establish itself as a bank.

Section 13(2) of the Act could be amended to provide that *the Registrar should issue a license for the establishment of an Islamic bank when the aims and operations of the banking business which it desires to carry on will not involve any element which is not approved by the religion of Islam.*

The Registrar should also see to it that a *Sharia Advisory Council* be established to guide him in ensuring that the bank is complying with Islamic tenets.

Section 7 of the Act provides for banks to furnish the Registrar from time to time with such information as may reasonably be required to ascertain whether or not it is in compliance with all rules. Banks will have to finance projects which will be in strict compliance with the Sharia, that is, in accordance with Islamic injunctions.

- As regards monetary policy instruments it could briefly be mentioned that most of the monetary policy instruments available to the central bank would remain largely unaffected by the operation of an Islamic bank.

Open-market operations would still be available in the new system; however, an Islamic bank will not hold any interest-bearing securities. In respect of the maintaining of reserves with the Reserve Bank an Islamic Bank could, just out of prudence, maintain a cash reserve with the South African Reserve Bank.

The instrument of discount rates or bank rates as a monetary policy would not be available to an Islamic bank since this represents the rate of interest at which banks borrow from the central bank to meet temporary shortages in liquidity. Since this tool cannot be used by the Islamic bank, provision could be made to regulate the profit and loss sharing ratio between depositors and the bank on the one hand and between the banks and the investors on the other hand.

In respect of liquid asset requirements an Islamic bank would not hold any interest-bearing securities .It is not intended to discuss this issue here exhaustively as this in itself could be an area for further research;

however, Mudarabah participation can be offered to the public in the form of unit trusts or mutual funds which could be either close-ended or open-ended. Close-ended Mudarabah certificates could be traded on the stock exchange whilst open-ended Mudarabah certificates, like a unit trust, could be more convenient for and popular with the investing public due to their easy encashment by the Mudarabah company (the bank).

Such changes of and amendments to banking legislation would not affect the functioning of the traditional system of banking which rests on the principle of certainty of capital and certainty of return on it.

The amended laws would be directed specifically to serve the needs of the Muslim community whose religious edicts preclude them from dealing in interest-based transactions. The rigid financial intermediation of an interest-based system will be replaced by a system of participatory financial intermediation in which there would be participation for the common benefit without excluding the risk factor: in the event of a loss, it will have to be borne by all parties involved.

### **7.3 OBJECTIVES OF AN ISLAMIC BANK**

The main objectives of the envisaged Islamic bank would be as follows:

- To render to all Muslims contemporary Islamic financial services, thereby assisting Muslims to conclude all their financial dealings in strict accordance with Islamic Sharia.
- To develop the means of attracting funds and savings and channelling them into non-usurious banking transactions.
- To provide the funds to those particular sectors that would not receive full benefit from usurious banking transactions.

## **7.4 ESTABLISHMENT OF AN ISLAMIC BANKING ENTERPRISE AS A SOLUTION TO THE ECONOMIC CRISIS**

### **7.4.1 Introduction**

It has already been pointed out in Chapter 2 that a bank's main role is to take deposits from its customers and to make those available to borrowers who are in need of money. In so doing, Hefferman (1996:15) states that conventional banks become debtors to those parties lending it money, while the bank's borrowers in turn become the debtors of the bank. Banks therefore derive a major portion of their income from the interest differential between the rates of interest that it pays to its depositors and the rate at which it lends to its borrowers (Falkena, Kok & Van der Merwe, 1992:24). Goosen *et al.*(1999:36) notes a further role of the bank: its unique capacity to create credit. This is better known in the banking circles as the money multiplier which was explained in Chapter 2. In brief the money multiplier enables a bank to lend out a portion of the depositors' funds at a charge to borrowers by way of interest. The borrower then deposits such a loan either in the same bank or another bank in which a portion of this money will be lent out to other prospective borrowers. Therefore money can be created today by the central bank and the banking system as a whole.

The creation of money by the banking sector from deposit to liability ratio and compounding interest does not represent the real economy, simply because there is no corresponding productive involvement and hence it would be more appropriate to say that it represents the financial economy. It is even possible that the apparent creation of money could exceed the total money that is circulated in the system, and, if left uncontrolled, this could lead to chaos in society. This would occur because the total amount of money that is created is greater than the real money available in the market. The resultant chaos in society will result in the public losing trust and confidence in the banking system which could result in a massive withdrawal of funds from the banks. According to

Alrazi and Hamid (2004:9) money is represented today by pieces of paper as nonredeemable official notes whose quantity can be increased at will. Willis (2004:1) cites Vadillo's view on paper money that it is money without any intrinsic value and therefore, when given in exchange for any other valuable good (food, clothing, oil, or any other material object), it represents to a great extent "contractual fraud". He states further that gold or silver coins of a known integrity or purity in agreed amounts would constitute a legitimate trade of value for value.

Obviously it would be a rather difficult task to have a recast of the existing banking laws so as to provide for the easy entry and functioning of an Islamic bank. The main point of difference between a conventional bank and an Islamic bank is that whilst the conventional bank ensures capital certainty for its depositors, the Islamic bank provides no such guarantee for its capital and it is precisely this that in essence makes the Islamic bank and the conventional bank fundamentally different from each other.

It therefore stands to reason that Islamic banks which advocate profit and loss sharing could encounter many problems in their application to the banking authorities for a banking licence. In fact, Gafoor (2006:35) corroborates this viewpoint when he cites Sir Leigh Pemberton, the Governor of the Bank of England, as making the following remarks to the Arab Bankers' Association in London:

A central feature of the banking system of the United Kingdom as enshrined in the legal framework is that of capital certainty for depositors. It is the most important feature which distinguishes the banking sector from other segments of the financial system.

The Bank of England is not legally able to authorise under the Banking Act an institution which does not take deposits as defined under the Act. Islamic banking is a perfectly acceptable mode of financing but it does not

fall within the definition of what constitutes banking in the United Kingdom.

The Islamic facilities might be provided within other areas of the financial system without using a banking name.

As a consequence of these prevailing circumstances, Islamic bankers are advised to take heed of the remarks made by Sir Leigh Pemberton that they remove the word “bank” from the equation and operate as a business enterprise modelled on the basis of a partnership, public company or a private company in order to provide for the easy entry and functioning of Islamic financing. As a financing or investment company, most of the services attributable to traditional banking can be offered without the having to comply with the strict regulations applicable to conventional banks.

There are many advantages of not using the word “bank”, some of which can be summarised as follows:

- Control and supervision by the banking authorities would be absent since the Islamic business enterprise would no longer be burdened to comply with the Banks Act.
- Muslims will be able to conclude all their financial dealings in strict accordance to Islamic Sharia without any impediments from the banking authorities; they can thus participate freely in the profit and loss sharing system of financing.
- Such Islamic business enterprises would be free to operate across national boundaries.
- The system of profit and loss sharing through Islamic investment enterprises could be a means to provide responsible financing for socially and economically relevant projects.
- The stringent requirements as set out by the Basel III accord that invoke the introduction of minimum liquidity standards and the monitoring of the

liquidity coverage ratio (LCR) of financial institutions will no longer be applicable to such business enterprises.

- Maintaining the minimum liquidity and reserve ratio with the Reserve Bank and the resultant earning of interest on balances held will no longer apply. Islamic Banks that earn interest are required not to use such monies for themselves but rather to donate those to charitable organisations. If Islamic banks are not required to maintain such minimum liquidity and reserve ratios then the funds as such could be invested in profit and loss sharing joint ventures which could provide a lawful income for the shareholders and depositors.
- Providing an alternative for services that an Islamic finance company would not be able to provide but which banks are allowed to provide:
  - Finance companies are not allowed to accept deposits but clients could be issued with debentures for money held by such companies. Finance companies are also not allowed to grant loans that bear interest but clients could enter into a profit and loss sharing relationship with a finance company.
  - Finance companies may not grant overdraft facilities to a client but could possibly grant a no compensation loan to certain clients.
  - Finance companies will not invest in any products and services that are categorised as unlawful in Islam. They would in effect invest their funds in viable projects allowed by Islamic law.

#### **7.4.2 Islamic principles as basis of an Islamic business enterprise**

An Islamic business enterprise would be established as a joint stock company strictly observing Islamic principles and would operate in terms of the new Companies Act 71 of 2008. The following Islamic principles would apply:

- Allah owns all the wealth in the world and the bank only acts as a trustee.

- The bank will exist to promote the real economy instead of the financial economy.
- It will discourage debt and encourage Musharaka, or joint profit and loss sharing.
- The bank will be an active partner in business ventures and provide consultation to its partners.
- It will encourage spending on savings, not on credit.
- It will encourage creation of new business and entrepreneurship.
- It will endeavour to educate Muslims on the principles of Islamic finance.

#### **7.4.3 Adoption of the dinar (gold coin) and dirham (silver coin) model**

The envisaged Islamic business enterprise could possibly adopt as their unit of currency the dinar (gold coin) and the dirham (silver coin). The gold dinar and the silver dirham would be represented by actual coins that would contain a certain weight of gold and silver. In this case the dinar would contain 4,2 grams of gold and the dirham 3 grams of pure silver. This would facilitate small transactions to occur using gold and silver coins.

According to Vadillo (1996:53) gold is the most sound and stable currency in the world and its value has remained stable in relation to other basic commodities. One big advantage of gold is also that it is universal, identical in Britain as it is in South Africa and hence it would be perfect for use in international payments without having to concern oneself with the unpredictableness and costly exchange rates of all other paper currencies.

#### **7.4.4 Advantages and disadvantages of using the gold dinar and silver dirham**

The gold dinar and the silver dirham could be ideally suited as currency as they have an intrinsic value of their own and are worth something which is essential

for the existence of a balanced economy. They could also be termed real money since they cannot be manipulated and created from nothing, as fiat money can. In brief the advantages and disadvantages of gold and silver as currency are as follows:

### ***Advantages***

- It would be impossible to create or print it or to control its supply.
- Gold and silver are natural resources and are inherently limited; its quantity cannot be artificially increased.
- The dinar and dirham are also different from fiat money in that a hundred per cent reserve and liquidity requirement would be required, but fiat money's existence, as has been pointed out earlier, would promote the money multiplier effect and interest changes.
- In respect to transactions tangible money will duly change hands, and hence value for value will be exchanged.
- The interest income that would otherwise be obtained from the money multiplier would be non-existent.

### ***Disadvantages***

- The introduction of the dinar and dirham as currency would be faced with many practical problems, challenges, and rebuttals by those who for some reason might be averse to it.
- The creation of a unifying paper currency also poses an additional problem because in order to become operational such paper currency would have to compete successfully against the US dollar from day one.
- There is also the concern of how the dinar and dirham will fit into a system of electronic money transfer and how payment will be made in respect of transactions worth millions of rands.

The potential use of the dinar and the dirham certainly is an interesting theory but it is not feasible in the Western world; also not for an Islamic bank. However, this

matter could serve as an area of further research.

The Islamic business enterprise would thus be established as a joint stock company strictly observing Islamic principles. A number of individuals called shareholders would supply the necessary capital, participating in business with a view to sharing profit and loss proportionately as has been explained earlier on. The minimum number of participants would be two whilst the maximum number would be unfixed. However, it could be appropriate to indicate a ceiling for operational convenience. The amount of capital provided by each shareholder may be equal or it could vary. The shares may also be fixed at a price and shareholders would be encouraged to purchase as many shares as they would like. The minimum and maximum limits of the subscribed capital may also be specified. In this way every shareholder will become part of the business enterprise.

## **7.5 OPERATIONAL MECHANICS OF AN ISLAMIC INVESTMENT COMPANY**

The Islamic investment company will be open to both members of the Muslim and the non-Muslim community without any discrimination on the grounds of religion, creed or race. It will operate on sound business principles, keeping in view the criterion of security, liquidity and profitability at all times. The company will shun all interest-based transactions; it will neither borrow nor lend on interest. It would also not purchase or hold any interest-bearing instruments such as government bonds, treasury bills, bankers' acceptances or any other interest-bearing securities. It will, however, conduct its financial operations along the lines as explained below.

The company will enter into a participatory financing relationship with prospective investors who will share profits with the company on the basis of Mudarabah (trust funding). The company will open an investment account for the investors.

### **7.5.1 Investment account**

The company will open an investment account for those who wish to invest for a particular period of time, for instance for a period of three, six or twelve months or more. The minimum amount for investment deposits would be fixed at an amount deemed appropriate. In respect of this deposit the depositors will authorise the company to use their money at its discretion to finance certain lawful profit-earning investments. The company and its investors will share any profit realised on the basis of Mudarabah (trust funding). Also any profits earned on investment of the depositors' funds will entitle the company to a certain predetermined percentage for administrative costs that it has incurred it and for any services it has rendered in acting as an agent. The remainder will be distributed among the depositors in accordance with their daily deposits. The predetermined profit-sharing percentages between the bank and its depositors in respect of the different categories of deposits will vary. All depositors on the investment side will be treated as separate pools, each directed to a select group of investments. Each depositor will get a share of the profit in proportion to its relative size in the pool to which it belongs. Specific investments may also be made by a client who agrees with the bank to invest his money in a particular project. In this case the owner of the investment will have to bear all the risks associated with the placement of his deposit.

The investor will not be allowed to withdraw his investment fully or partially before the expiry of the specified period unless acceptable under certain circumstances to the board of directors. In the event of withdrawal being approved the depositor should be prepared to give up his total or partial share of profit for the financial year in which the withdrawal was affected. In the event of a loss occurring on investment of the funds deposited by the depositor, the same will be distributed amongst them strictly in proportion to the daily product of their deposits, while the loss of the bank in this regard will be in terms of its efforts having been in vain.

### **7.5.2 Distribution between shareholder's profit and depositor's profit**

Unlike conventional interest-based banks where all the profits accrue to the shareholders of the bank, the envisaged Islamic investment company will make a distinction between profits belonging to the shareholders of the company and profit belonging to the depositors of the company. Any income that is earned other than through the employment of the profit and loss sharing investment deposits will be available for distribution to the shareholders.

### **7.5.3 Financing and investment operations**

The envisaged Islamic financial company will carry out non-usurious financing and investment operations by adopting the following financing methods:

- Musharaka (fixed-term joint venture participation)
- Mudarabah (trust funding)
- Qard-al-Hasna (interest free loan)
- The provision of other services on the basis of a commission or a fee

The literature study undertaken has shown that the most common modes of financing employed by Islamic banks are that of Musharakah (mutual participation), Mudarabah (trust financing), Ijara (leasing), Ijara-wa-Iqtina (lease purchase financing) and Murabaha (financing purchase with fixed profits). The Mudarabah and Musharakah modes of financing are profit and loss based whilst Ijara, Ijara-wa-Iqtina and Murabaha are profit based. Risk sharing is the essence of Islamic finance and it therefore stands to reason that the Islamic financial system requires those kinds of Institutions that support risk sharing. Today Islamic banks are very reluctant to hold onto risk sharing assets and to engage in profit and loss sharing ventures (Iqbal & Mirakhor, 2011:68). The results from the empirical study suggest that Islamic banks give greater preference to financial instruments such as leasing and Murabaha (cost plus fixed profit).

**Table 7.1: Asset composition of select Islamic banks**

	1999	2000	2001	2002
Murabaha and deferred sales	80,1%	83,0%	86,7%	84,3%
Istisna	10,8%	8,7%	7,5%	7,0%
Ijarah (leasing and hire purchase)	2,5%	2,4%	1,9%	2,9%
Mudarabah (partnership)	1,6%	1,6%	1,2%	3,1%
Musharakah (equity participation)	0,9%	0,8%	1,3%	1,2%
Qard Hasan	0,2%	0,3%	0,4%	0,5%
Other	0,2%	0,2%	0,5%	3,0%

Source: Islamic Banks and Financial Institutions Information Systems (IBIS), 2007

Table 1 shows the asset composition of select Islamic banks which corroborates the fact that their first preference is trade-based, short-term and fixed-profit financial instruments. The Islamic banks seem very reluctant to use Mudarabah and Musharaka financial instruments; the reason for this, according to Iqbal and Mirakhor (2011:160), is that there is a lack of appetite for risky assets. This points to the fact that these banks' main objective is to preserve depositors' principal investment amount and further to enable the Islamic banks to provide low-risk and safe investment opportunities. For example, Table1 shows that the share held by equity and other partnership-based instruments like Mudarabah and Musharakah is in fact less than 10 per cent which is different to what has been proposed by many Islamic authors.

Gafoor (2009:58) cites Prof Kurshid Ahmed who says that the Sharia assumes that the financier in Murabaha transactions actually buys the goods and then sells them to the client. Unfortunately the current practice of "buy-back on mark-

up” is not in keeping with the conditions under which Murabaha is permitted, for that which is being practised is a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This goes against the letter and spirit of Sharia injunctions and he asserts that this practice is very similar to Riba or interest and hence suggests its discontinuation.

On the same issue Gafoor (2009:58) also quotes Dr Hasanuz Zanam who states that in practice the bank neither buys, possesses nor actually sells and delivers the goods, but the transition is assumed to have taken place. By signing a number of documents of purchase, sale and transfer they might fulfil a legal requirement but they do so at the expense of violating the spirit of prohibition.

On the issue of Ijara (leasing) the simple question that arises is that since banks are not trading houses, can they then act as owners of cars, machinery or real estate so as to assume the role of a lessor, and also act as stockists to buy and resell the entire stock of imports and exports that may be needed by traders?

According to Usmani (2002:158-159) in respect of Ijarah or leasing he likens the rules of Ijara to the rules of sale, for he argues that in both cases something is transferred to another person for a value consideration. The only difference between Ijarah and sale is that in the latter the corpus of the property is transferred to the purchaser whilst in respect to Ijarah the corpus of the property remains in the ownership of the transferor and only its usufruct (e. the right to use it) is transferred to the lessee. He therefore draws justification for the practice in seeing Ijarah not as a mode of financing in its origin, but rather as a normal business activity. It is in particular due to some tax relief regulations that are applicable to this kind of transaction that it is also being used in Western countries for the purposes of financing.

According to Usmani some financial institutions, instead of giving a simple interest-bearing loan, started to lease some equipment to their customers. The

rent in respect of this equipment was calculated by computing the total cost that has been incurred in the purchase of the assets and adding to it the stipulated interest that they could have claimed on such amount during the lease period. The aggregate amount so calculated is divided by the total months of the lease period and the monthly rent is fixed on that basis. The question of whether or not the transaction of lease can be used as a mode of financing according to Sharia principles depends on the terms and conditions of the contract. The opinion held here is that this kind of leasing falls within the domain of specialised leasing financial institutions

Ahmed, Iqbal and Khan (1983:109-110), in an article entitled *Elimination of Interest from the Economy* which was a report of the Council of Islamic Ideology (Pakistan), assert that the real alternative to interest under an Islamic economic system are profit and loss sharing and Qard-al-Hasna, which is lending without any additional charge over and above the principal amount. Murabaha and leasing, though free of the element of interest, are no more than second best solutions from the viewpoint of an ideal Islamic economic system. Moreover, these authors also see it as a danger, for it could eventually be misused as a means of opening the back-door for interest-based transactions. They are therefore of the view that the financial instruments of Murabaha and Ijara (leasing) as modes of financing be kept to a minimum extent and only be used in situations of extreme necessity. They should never be allowed to be used as general techniques of financing.

According to Usmani (2002:152) there should be a time period during which the risk of the commodity should be borne by the financier. He further asserts that one of the foremost conditions of Murabaha to be valid is that the commodity as such should come into the ownership (physical or constructive possession) of the financier before he could resell it to the customer. He also maintains that the financier's best way to effect Murabaha should be where the financier himself purchases the commodity directly from the supplier and after delivery sells it to

the client. However, making the client an agent to purchase on behalf of the financier renders the transaction dubious. Therefore he is of the opinion that the agency concept should be avoided as far as possible.

All four sources mentioned (Ahmed, Iqbal & Khan, 1983:111; Mirakhor, 2011:271; Gafoor, 2009:46 and Usmani, 2002:152) seem to support the notion that the operational field of profit and loss sharing and Qard-al-Hasna be expanded whilst that of other alternatives be reduced.

Iqbal (2007), in his article on the challenges facing the Islamic financial industry, makes an important point, namely that by design Islamic banks were supposed to be pass-through financial intermediaries where the profit or loss realised on the assets is passed to the investors (depositors). In addition the Islamic financial system encourages risk-sharing financial contracts which implicitly favour equity- and partnership-based financial instruments; however, in practice things are very different from the theory in both aspects. In particular in the case of risk-sharing instruments, there appears to be a greater affinity towards trade-based, short-term and fixed-income instruments. Khan (2006:29) cites an interesting remark made by the Federal Sharia Court in its judgement on Riba that although leasing is permissible in Sharia it should be used minimally in the banking system because the best modes in the Islamic system as alternative to the present banking system are Mudarabah and Musharakah which are based on profit and loss sharing between the parties according to Sharia principles.

#### **7.5.3.1      *Financing techniques***

In the light of the above the following financing techniques are therefore proposed insofar the establishment of a model for an Islamic financing institution is concerned. In this study it has been found, through the literature study and empirical research in respect of Islamic banks, that their operative strategy employed is more or less the same as far as the financing tools of Musharakah

and Mudarabah are concerned. Each of these will be explained briefly.

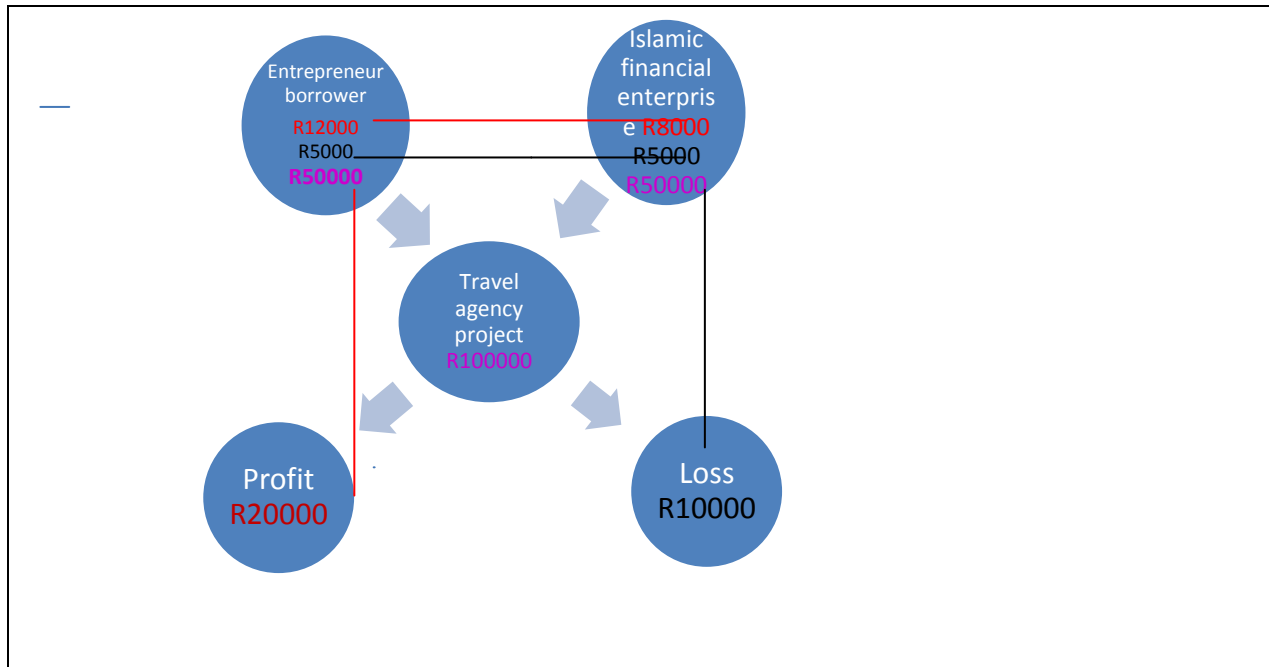
- **Musharaka (mutual participation) financing model**

In this form of financing the bank and the entrepreneur will enter into an agreement whereby each provides a portion of the capital requirement. Profit and loss will be shared on a pro rata basis with special consideration being given to the efforts of the entrepreneur. Figure 7.1 below shows a simple Musharaka financing model in which the client and the Islamic investment company inject an equal amount of capital of R50 000 each into a travel agency project. The parties enter into a contract in terms of which they intend to distribute the profits in the ratio 60:40 for the client and the company respectively (a higher ratio is accorded to the client as he will be managing the project). Any loss in terms of the agreement will be shared equally. The investment company can leave the responsibility of management to the client whilst it could retain the right of supervision for itself.

An example of how this proposed financing model could work is presented below:

**Figure 7.1 : Simple Musharakah model**

Key: Contribution – Profit - Loss



Source: Adapted from Abdullah & Chee (2010:183 )

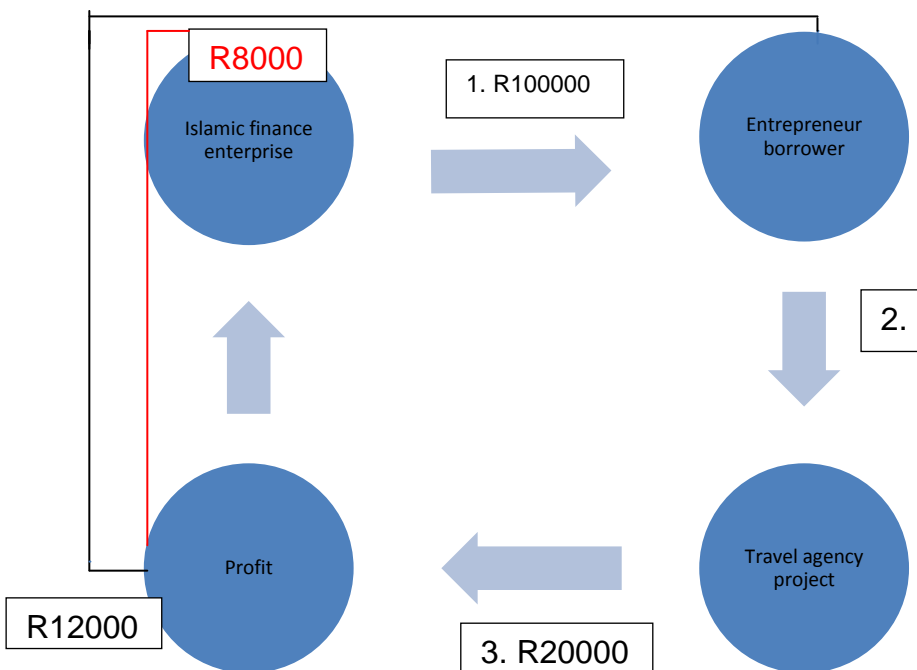
In Figure 7.1 above the investment company and the entrepreneur both agree to contribute R50 000 each towards the establishment of a travel agency project. The entrepreneur is the main party who is entrusted with the management of the project. In the event of the project realising a profit amounting to R20 000, then in accordance with the agreement between the parties as to the ratio of 60:40, R12 000 or 60% will be in favour of the entrepreneur and R8 000 or 40% will be in favour of the investment company. In the event of the project realising a loss of for instance R10 000 then such a loss will be shared equally between the parties at the rate of R5 000 each, in proportion to their capital contribution. According to Iqbal and Mirakhor (2011:87) the Sharia is very clear in respect of this, that if a party has not invested any capital in the partnership then it is not liable for the loss. The implication of this is that any capital investment is subject to the risk of loss of capital; however, any investment of labour or time as such is limited to the loss of such labour or time invested.

Should the project be profitable, the finance company will earn a return of 16% on its investment and the entrepreneur will earn a return of 24%. The entrepreneur may regard this as expensive financing when compared to the rates charged by interest-charging banks; however, it must be pointed out that should the project make a loss, conventional banks give no relief, but the Islamic finance company shares in the loss.

- **Mudarabah** (trust funding) financing model

Alternatively the Islamic investment company could undertake financing on the basis of Mudarabah which refers to a financing operation in which the investment company will provide the capital whilst the entrepreneur contributes his skill or efforts. The profits are shared according to a predetermined percentage but in the case of loss not involving negligence or breach of contract by the entrepreneur, the investment company will lose its money. Figure 7.2 below illustrates the working of a simple Mudarabah financing model.

Figure 7.2 *Simple Mudarabah model*



Source: Adapted from Abdullah & Chee (2010:181)

Let us suppose that an entrepreneur has a business idea to set up a travel agency primarily focusing on the facilitation of Hajj travel (Muslims are required to go and visit the Holy Lands of Mecca and Medina once in their lifetime) and approaches the investment company for funding. The company will review the business plan and if it is deemed feasible would then fund the project. The entrepreneur would obtain financing of say R100 000 from the company and the parties agree to a profit-sharing ratio of say 40:60; that is, 40% to the company and 60% in favour of the entrepreneur since he is also managing the project.

In the event that the project realises a profit of for instance R20 000 then 40% or R8 000 is the share that will be allotted to the company whilst 60% or R12 000 would be allotted to the entrepreneur. However, in the event of a loss the company will be solely responsible for bearing the loss whilst the entrepreneur will lose out by way of his efforts having been in vain.

The earliest Islamic business partnership goes back to Prophet Muhammad (Peace be upon Him) himself who acted as an agent or as a Mudarib for his wife Khadija when he undertook several trade expeditions on her behalf. The real alternative to the traditional system of banking within an Islamic framework seems to be that of profit and loss sharing which is in actual fact a shift from a debt-based transaction to an investment-based model of funding. The profit and loss system of financing seems to serve as an ideal environment which besides ensuring a healthier financing system and promising a higher return to investors also leads to an optimum allocation of resources for the overall economic growth and welfare of society. There are however other modes of financing besides Musharaka and Mudarabah that are adopted by Islamic banks as can be seen from the literature study, such as Ijara (leasing or a rental contract), Ijara-wa-lqtina (lease purchase financing) and Murabaha (financing purchase with fixed profits). However, these latter modes of financing could be bombarded with criticism and hence the model proposed is that of making use of Musharaka, Mudarabah and Qard-al-Hasna.

- **Qard-al-Hasna** (the granting of interest free or benevolent loans)

With the belief in its obligation to the community the Islamic investment company should always provide no-compensation loans for events such as the following:

- Marriages
- Prolonged or expensive medical treatment
- Debts and hardships
- Disasters, accidents and deaths
- Delayed payments of salaries and wages for reasons beyond the person's control.

Each case will be considered by the board whose decision will be binding and the maximum amount advanced will be decided by the committee. If after repeated postponement of repayment it becomes clear that the borrower may not be able to meet his debt, the loan will be written off under the authorisation of the committee. Defaulters without a valid reason will be required to pay a fine or will be debarred from taking advantage of the loan facility in future. Fines will be paid over to the Zakaat fund.

#### **7.5.3.2 Other services**

The Investment Company will also provide other services for the purpose of generating income on the basis of a commission or fee, for example in the following instances:

- Purchase and sale of foreign currency
- Purchase of shares on behalf of clients
- Renting of lockers and safes
- Acting as trustees and executors

- Providing consultancy services to clients
- Safe custody of documents
- Management of properties

#### **7.5.3.3 *Share investment***

In order to earn some profits from its liquid funds and also to maintain its liquidity level, the Islamic investment company will buy government industrial shares and shares of different industrial and commercial firms which are lawful under Islam. The diversification of investment will ensure overall profits on its investment at all times. If there is a loss or no profit is realised on some share, it will be neutralised by profits on others. Therefore, in order to avoid the risk of loss, the company's policy will be to spread out its investment by buying various types of shares in the market.

#### **7.5.3.4 *Direct investment***

The Islamic investment company will also invest funds directly in certain projects of their own or other developmental projects undertaken in collaboration with the government or some other financial institution. These projects could be long-term projects and the decision to participate in them or not would depend on the liquidity position of the bank. Since large amounts of capital would be involved and the period would also be long, this type of investment has the advantage of fulfilling some social objectives and the expected profit that might be generated. However, the company will not invest in projects involving any luxury or non-essential goods or in any project not compliant with Islamic Sharia.

#### **7.5.3.5 *Realisation of investment profits***

The account of the profit and losses relating to financing and joint investment activities will be separate from the income and expenditure of other activities and

services of the Islamic enterprise so that there is a clear distinction between the profit belonging to the shareholders of the company and profit belonging to the depositors of the company. In respect of income earned through other methods than the employment of the profit and loss sharing investment deposits such income then rightfully would be earmarked for distribution to the shareholders. However, the total profit from all activities will have to be reflected in the comprehensive income statement of the company. The same will apply to the income and expenditure of specific investments where each specific project will have separate accounts.

The company will adopt a system of accounting that confines itself to the profits actually realised by operations financed by the company. The various financing operations will bear all the direct expenses and costs arising therefrom, and these will not be charged to the general expenses of the Islamic investment company.

#### **7.5.3.6      *Investment risk reserve fund***

The bank will allocate a percentage of its net investment profit realised from its various operations to an investment risk reserve fund. The main reason for this will be to avoid announcing losses in any quarter and also to avoid wide fluctuations in the rate of profits. (It is good to have reserve funds as a form of security, but the reserves cannot be used avoid fluctuation in profits. The correct profit for each period will have to be reported.) Therefore the investment risk reserve fund will retain part of the profits in order to compensate for any losses that might occur. This will be done both in relation to depositors and shareholders.

#### **7.5.4      *Distribution of dividends***

The company will publish the general percentage of profit allocated to the total

funds participating in joint investments at the beginning of the financial year. The company joint venture would deduct its percentage share of the profit and the balance would be distributed to the investors. The bank would also be entitled to a share in the profit in proportion to its own invested funds or the funds which it may authorise to invest at risk. The bank as an agent will bear any losses that might ensue as a result of default on its part such as cases of fraud, or negligence on the part of any members of the board. Any losses that might ensue as a result of normal business activity would be deducted from the total profits realised for the year in which such losses occurred. Any excess of losses over the profits which were actually realised during that year will be deducted from the investment risk reverse fund account.

If the total profits realised in a year together with the reserves accumulated from the previous years are not sufficient to cover the losses incurred, the company will then carry out a detailed assessment to find out the estimated profit and loss based on market rates from operations which are financed by Mudarabah (trust funding) that have not yet reached the stage of settlement. If the result of such assessment indicates that the estimated profits could possibly cover the excess loss, then the bank will round such loss against such estimated profits. If the estimated profits are less than the excess loss the bank may treat it as a rounded loss provided that the amount withdrawn from the joint investment deposits will bear its share in the excess loss.

### **7.5.5 Management of the bank**

The Islamic financial enterprise would be managed in the very same manner as any other company registered in terms of the Companies Act is managed. There shall be a board of directors who will be elected by the shareholders and whose powers will enable it to carry out its work with the necessary flexibility.

Their main function will be the following:

- Organisation and management of the bank.
- Drawing up of the rules and regulations relating to the acceptance of deposits and methods of calculating predetermined percentages.
- Developing the policy to be adopted with regard to investment of funds.
- Determination of fees and commission that the Islamic bank may levy in respect of its various activities.
- The expansion of various fields of investment and the adoption of new methods for the development of non-usurious banking activities.
- Allocating signature authority to the employees of the Islamic bank.
- Preparation of the annual report and review of balance sheets prior to their presentation at the annual general meeting.

No person who has been convicted of any criminal offence such as dishonesty, fraud or forgery shall be a member of the board. The chairperson or any other member of the board shall have no direct interest in contracts, project and undertakings concluded with the Islamic bank.

The company will also be in compliance with corporate governance regulations by ensuring sustainability and respecting the interests of all stakeholders, as detailed in the King III report.

#### **7.5.6 Religious Supervisory Board**

The Islamic enterprise will appoint a Religious Supervisory Board whose members will be learned and specialised in Islamic law, economics and accepted doctrinal opinions. The main function of such a board would be to see to that the company's operation is devoid of any usurious dealings and that it complies in totality with Islamic tenets. It will not adopt the same functional role as that which the Banks Act, the Reserve Bank supervision and Basel III play in conventional banking.

### 7.5.7 Staffing

All employees will be required to undergo an Islamic banking training course as well as programmes to enhance their knowledge on an on going basis and to keep them abreast of new professional and technological development in their relevant fields. The company will employ both Muslim and non-Muslim personnel as long as they possess the required expertise and qualifications.

### 7.5.8 Zakaat fund

The company will also establish a Zakaat (compulsory charity) fund. The Zakaat contributions would be paid from the company's shareholders' profit. It would also accept Zakaat for other parties who deputise the bank to pay the Zakaat from their money and the bank will distribute the Zakaat for charity purposes.

### 7.5.9 Risk

All banks, whether conventional or Islamic, face a wide range of risks. In particular Islamic banks face two types of risks in conducting their operations: those that are similar to the risks of conventional banks, and specific risks that are unique to them because of their adherence to Islamic Sharia. They also face constraints in managing liquidity since they cannot use any interest-bearing instruments. The view of Islamic law on Gharar (risk) has been discussed in detail in Chapter 4.

In brief some of the risks that an Islamic banking enterprise may face are outlined by Iqbal and Mirakhor (2011:276-298), and their exposition is followed here.

**Credit risk:** This is basically due to the failure on the part of the opposite party to meet its obligation on the due date, or it may be a reference when there is a deterioration in the repayment capacity. The credit risk

management of an Islamic bank is more complicated than that of conventional banks which could be attributed to the prohibition imposed on Islamic banks on charging any accrued interest or imposing any penalty except in the case of deliberate delay. It is in fact during this delay that the bank's capital remains stuck in non productive activity. Moreover the bank's investors or depositors are not earning any income. In order to minimise the risk, Islamic banks need to undertake to carefully evaluate the profitability of the projects that they would be financing since it would itself be taking risks in the projects financed. Therefore an Islamic bank would have to develop expertise to the extent that its resources permit but beyond that it would also seek advice of a consulting firm specialised in the project and area concerned.

**Business risk:** It is of course true that business risk is also a problem for the portfolio manager of the interest-based bank, for he also has to be constantly aware of the quality of his entire portfolio and to guard against loss through market failure. Such a risk, however, would be more pronounced in respect of an Islamic bank since they would not be receiving a predetermined rate of interest, and furthermore, as partners in the business equity, they would not enjoy lien on the client's. On the other hand this would tend to have a healthy effect on the Islamic economy as it would eliminate most of the careless and imprudent financing that is undertaken by banks simply on the assurance of repayment of the principal sum with interest. This kind of business risk would be minimised by an Islamic bank. First the Islamic bank would undertake a proper examination of the business or project being financed to ensure that it is sound, and second it would implement a system of proper planning and diversification of its Mudarabah portfolio by maturities as well as by borrowers and sectors of the business. The Islamic business enterprise will make every attempt to diversify its portfolio in a proper manner so that there would be little likelihood of a net loss except in exceptional

circumstances.

**Liquidity risk:** The perception that exist in the minds of many is that Islamic banks operating on profit and loss sharing will make the banking system less liquid and run the great risk of bank failures due to the inability of the banks to meet the withdrawal demand. One needs to bear in mind that there are in fact three factors which are germane to the possibility of defaults: firstly to whom finance is provided, secondly the purpose for which the finance is provided and thirdly what type of supervision is exercised by the financial institution on the end use of the resources. These elements remain essentially the same whether applied to an interest-based bank or to a system based on profit and loss sharing. The Islamic investment company will therefore endeavour to put in place a comprehensive risk management and reporting process to identify, measure, monitor and control the risk associated with profit and loss sharing contracts. These risk management activities and processes will require active oversight by the board and senior management

**Solvency risk:** A solvency crisis could arise when the amount of bad debt that has to be written off exceeds the equity capital of the bank, thereby making the bank technically insolvent. Not only does the bank lack ready cash as in a liquidity crisis, but also sufficient real assets to support its deposits and sustain losses. Since interest-based banks are highly susceptible to such eventualities, even a loss of around 5% of assets can create a solvency crisis. Therefore temporary accommodation from the central bank provides such banks with a brief respite that enables them to survive until remedial measures are enforced. In an Islamic bank the solvency crisis would be of a lesser degree of gravity because of the relatively large equity base of the bank along with substantial volumes of Mudarabah deposits. These should be sufficient to protect demand depositors. Further insurance of demand deposit may be instituted to

prevent any run on banks; the central bank should also be ready to act as a lender of last resort

**Risk management:** The distinct risk profile of Mudarabah and Musharakah contracts which is a form of equity participation could possibly expose an Islamic enterprise to many different types of risks as outlined above. These risks will therefore require proper, adequate and sound risk management infrastructure and internal controls. An Islamic bank would therefore develop appropriate policies and procedures on profit and loss sharing contracts which naturally have to be clearly specified and communicated. For instance, the following have to be put in place:

- A systematic process to regularly review and update Musharakah and Mudarabah policies.
- An Islamic enterprise will also establish a dedicated committee or unit to oversee Musharakah and Mudarabah exposure and such a committee will comprise members with adequate knowledge and understanding of Musharakah and Mudarabah contracts and risks associated with such exposure.
- So as to mitigate the various risks in profit and loss sharing contracts the Islamic enterprise will ensure that in respect to valuation methodologies on profit calculation and allocations, it would implement appropriate, consistent and mutually agreed upon policies accepted by both contracting parties at the inception of the contract.
- Also subject to mutual consent, the contracting parties may appoint an independent party to carry out an audit on profit and loss sharing contracts so as to ensure transparency and objectivity in the valuation and distribution of profits.

- A company may also employ guarantors to mitigate risk exposure in profit and loss sharing contracts, for example, this could include a third party guarantor to secure the return of contributed capital in the event of fraud or negligence on the part of the client.
- An Islamic company will also adopt a mechanism to oversee and monitor progress of project financing or investment by having a representative for a specific project, for example, by having a project level committee.

## **7.6 SUMMARY**

The notion of presenting an ideal model of an Islamic bank is a very difficult and complicated task. It needs to be pointed out that whilst Islam prohibits interest it does not prohibit business profit, provided it is on an equity basis sharing profits with losses. In short, Islam in the modern business context allows shares but prohibits bonds.

According to Islamic belief Riba is condemned by Allah and Allah has declared war on Riba. Since the present conventional system of banking that is based on Riba (interest) has failed us miserably, there is now a dire need to look at Islam as a solution to the banking fiasco which has adversely impacted on the whole world. There are many issues which still remain unresolved and the only way of gaining more knowledge and expertise in the field of Islamic banking is by practising Islamic banking.

This chapter deals with some of the salient issues which could play an important role in establishing an Islamic bank within the greater Tshwane area. In brief these are the following:

- The Banks Act should be amended in such a way that profit and loss sharing on the basis of Islamic Sharia principles would be an accepted form of business practised by banks in South Africa.
- Reserve Bank rules and requirements should also change. Open-market operation could still be available to an Islamic bank with the proviso that it would not hold any interest-bearing securities. The instrument of the discount rate or bank rate as a monetary policy would no longer apply to an Islamic bank as these are interest based. Islamic banks should not be required to hold any interest-bearing securities in order to maintain their liquidity requirements. It would, however, out of prudence maintain a cash reserve with the Reserve Bank. It must be appreciated that an Islamic bank would be at a considerable disadvantage in facing the competition with interest-based banks because it will not have access to the money market.
- A system of gold and silver coins could be introduced. Gold and silver being natural resources are inherently limited and cannot artificially be increased like fiat currency.
- Islamic banks, in order to run effectively, need to comply with the many Basel III requirements such as maintaining minimum liquidity standards and also the stringent monitoring of the liquidity coverage ratio of financial institutions.

If the abovementioned amendments are really some of the requirements for the successful establishment of an Islamic bank then it would not be feasible to establish such a bank as it is highly unlikely that any of the abovementioned amendments will really materialise in a Western society in the short term. These envisaged changes will call for much deliberation and of course would also be time consuming; needless to mention the onslaught of

many rebuttals.

As an alternative the view that a finance company would be a better option in the prevailing circumstances has certain merits. Certainly such a finance company could provide banking services in accordance with Islamic Sharia principles and it could operate outside conflicting banking regulations. The operating of a finance company without being categorised as a bank will of course require some creativity and ingenuity. Servicing the banking needs of the Islamic business community through a properly structured finance company is a feasible alternative to establishing an Islamic bank.

It needs to be indicated that the existing Islamic banks are operating on what may be termed as an experimental stage of their development.

It would be very difficult to change bank laws overnight so as to facilitate the easy entry and functioning of Islamic banks in South Africa; hence in order to circumvent the control and supervision by the banking authorities it is advisable that Islamic investment companies be established so as to enable the Muslim communities to operate comfortably under its own edicts, primarily practising the financing modes of Mudarabah and Musharakah, a practice which was sanctioned by the Holy Prophet Muhammad (P.B.U.H) himself.

There are still many issues that need to be resolved and it might take some years before a complete model could be devised.

## CHAPTER 8: SYNOPSIS, RECOMMENDATIONS AND CONCLUSIONS

### 8.1 INTRODUCTION

The primary objective of the study as set out in Chapter 1 was to investigate the feasibility of the establishment of an Islamic banking enterprise in the greater Tshwane areas with regard to its long-term survival. There was strong consensus from the respondents that banks are indeed playing a pivotal role in facilitating business transactions. Both from the literature study and the empirical research findings the avoidance of interest was ranked as the most important factor that would lead to long-term support of an Islamic banking enterprise. Thus in order to secure credibility and success for an Islamic bank it clearly needs to be totally free from any interest-based or usurious dealings and it should scrupulously conform to Islamic Sharia law and principles. Failure to adhere to Islamic principles will result in a catastrophic blow to the success of the envisaged bank. Also in terms of efficiency an Islamic bank has to prove itself to be just as efficient as any conventional bank when it comes to the provision of essential banking services; the most important for the interviewed business people being current account and overdraft facilities. If the bank is unable to provide these basic requirements then the entrepreneurs would have no option but to patronise the interest-based conventional banks on the basis of necessity.

Arising out of the concerns identified in the literature and also by the respondents in the present study, some conclusions will be drawn and recommendations made towards the successful establishment of an Islamic business enterprise in the greater Tshwane area. In summarising, this study has been organised in three main parts:

- In the first part relevant literature on principles of banking, the general framework of Islamic law, the fundamental principles on which Islamic

banking is based, and the Islamic banking movements in different countries were reviewed.

- In the second part an empirical investigation was undertaken so as to provide a practical basis to ensure that a reasonably accurate version of the problems and challenges experienced by Muslim entrepreneurs in the business banking environment is given which measures up to the purpose of study.
- In the third part a simple model for an Islamic banking enterprise was developed on the basis of the findings from the literature and empirical study.

The main thrust of this chapter is to summarise the most pertinent points discussed in the earlier chapters as well as highlighting certain conclusions and recommendations. In summarising there will be some repetition, but this is necessary to serve as a synopsis and overview to readers before they read the complete text.

### **8.1.1 Literature study**

The review of the literature was conducted by means of secondary research in order to highlight the salient aspects of the study topic and also to guide the empirical investigation on which the findings are based. In Chapter 1 the following aspects of the study were addressed: the problem statement, the objectives of the study, the research methodology, the demarcation and limitation of the study and the structure and organisation of the study.

In Chapter 2 an exposition of the principles of modern banking was presented so as to place the role of banks in perspective. Such a review elucidated what is meant by a bank and it has also become evident by virtue of such a review that a bank's survival depends on confidence on the part of its depositors. Also highlighted in this chapter was the fact that a bank in acting as a business

organisation endeavours to maximise its profits by charging a higher interest rate on loans than what it pays to its depositors. It is therefore understandable that a bank in attempting to maximise its profits could possibly run the risk of being unable to repay deposits which could result in a loss of confidence and panic on the part of depositors. The banking system also has a unique capacity and that is its ability to create credit which in turn impacts directly on the money supply of a country. When uncontrolled this capacity, coupled with the desire to maximise lending, can have significant repercussions for the economy. Accordingly authorities in most countries find it necessary to control or influence the degree to which banks are allowed to create credit. Control of credit levels is in the hands of the central bank and it will therefore be of importance to consider ways in which such control can be affected. Since banks run their operation typically like any other business, the business aspects of South African banks were also discussed.

Chapter 3 focused on Islamic law since the ethical-legal component is the most important component that distinguishes the Islamic economic system from the other systems. This chapter also focused on and provided a general framework of Islamic law and the main sources from which this law emanates. The chapter also provided some general definitions of economics, Islamic economics and the nature of the Islamic economic system. The chapter further examined the crucial importance of Islam's attitude toward interest.

Chapter 4 draws from Islamic economic principles in order to identify the fundamental principles on which Islamic banking is based. Furthermore the profit and loss sharing (PLS) system, which forms the ethical basis for contemporary adaptations to Sharia-compliant business practice, was dealt with in this chapter. Also under scrutiny were the institutional and operational issues surrounding the PLS system, such as the establishment of Islamic banks, sources of capital and the bank's earnings. The chapter ended with a description of the Islamic banking movement as it started off in different countries and a review of the profile and

operations of some Islamic banks in practice.

### **8.1.2 Empirical research**

Chapter 5 was concerned with the empirical study. It focused on the research methodology employed as related to the issues relevant to the research. In this regard matters pertaining to the selection of data sources, the manner of acquiring the necessary information, the questionnaire design and the rationale behind each question used in the questionnaire were discussed. In order to achieve the objectives of this study a qualitative approach was used as it seemed to be the most appropriate and convenient one for securing the input, views and experiences from the various populations. The following two steps were employed in the collection of data.

- The first step entailed the selection of the data sources. The following groups of respondents were contacted to share their views and experiences which would be invaluable and also assisted in the construction of a model for Islamic bank survival. The group included Muslim owners of registered small- and medium-sized businesses (SMEs) in the greater Tshwane area. Since the sample frame of Muslim-owned SMEs consisted of a small number it was decided to interview all respondents, as random selection would be inappropriate in the given circumstances. To increase the sample size the snowballing sample technique was also implemented. A second group of respondents that was targeted were bankers who had the necessary experience in Islamic banking. With the help of business contacts three individuals who had a vast degree of experience in the business of Islamic banking and who were also associated with the Al Baraka Bank were identified. Finally a group of religious leaders who had expertise in the field of Islamic economics, finance and banking were also contacted and three such religious leaders were identified and interviewed.

- The second step involved the actual collection of the qualitative research data. A structured interview (based on a questionnaire) was used to acquire the necessary information. The interview system was used to determine the general trends and impressions and this mode of contact seemed to be the most convenient and effective way of soliciting the views of respondents. Lists of critical questions for the different groups were prepared and a further decision to have the pilot questionnaires tested on a selected group of individuals was taken. After pilot testing respondents were contacted by telephone and prebriefed as regards the purpose of the research and the key role that they would play as respondents. Thereafter a meeting at a time convenient to the interviewee was arranged. The views of the respondents were summarised in writing and entered in the prepared questionnaire. The responses of the various categories of respondents were tabulated, analysed and interpreted.

Chapter 6 dealt with a summary of the major findings and trends that came to the fore as a result of the field study and which of course served as a basis for the construction of a model for the establishment of an Islamic banking enterprise in the greater Tshwane area.

### **8.1.3 A simple model of an Islamic bank**

Chapter 7 dealt with the construction of a simple model of an Islamic bank. Based on the literature study and research findings from the field study a simple model of an Islamic banking enterprise based on Islamic Sharia principles was constructed, taking into account its survival within the greater Tshwane area and within the South African economic context.

## **8.2 OBSERVATIONS**

The objective of this section is to present the most important observations and

findings based on the research.

South African Muslim businessmen are averse to participating in interest-based transactions. As businessmen they still see their responsibility in the mobilising of savings and investment and creating employment for people which can only be achieved fully if they are allowed to operate within their own Islamic economic order.

It is true that in acting as financial intermediaries, banks do provide some essential services for the optimal functioning of an economy, and Muslims need these banking services just like anyone else. However, while interest-based transactions are a cardinal component of the conventional banking system, these have to be excluded from the Islamic economic system which then makes the Islamic economic system different from the Western economic system in respect of this key element.

The research conducted as described in Chapters 5 and 6 highlighted the need for an Islamic bank as long as such a bank avoids any interest dealings and operates in accordance with Islamic Sharia. It also emerged that it would be of central importance for the survival of such a bank to inspire complete trust and to show transparency and accountability in order to secure the confidence of depositors.

Further it was observed that for the viability of the envisaged Islamic bank, it was deemed important that the Banks Act should be amended as well as some Reserve Bank rules and requirements. Compliance to the rigid requirements as set out by the Basel III accord was also deemed necessary.

### 8.3 RECOMMENDATIONS

In view of the findings of this study the following recommendations for the possible establishment of an Islamic bank in the greater Tshwane area are made:

1. An Islamic bank should operate not as a bank but as a finance company which would still accomplish its pivotal role and enable Muslims to wholly subscribe to Islamic Sharia principles in banking. It would allow them to make economic contributions thereby promoting economic growth without any intrusions to their belief system. The real alternative to the traditional system of banking within the context of an Islamic framework seems to be that of profit and loss sharing which is in actual fact a shift from a debt-based to an investment-based model of funding.

Since Islam permits trade but forbids dealings in interest it seems that the profit and loss sharing system of financing would serve as the ideal environment insofar as the allocation of resources for the overall economic growth and the welfare of the society at large are concerned.

The main modes of financing recommended would be that of Mudarabah, Musharakah and Qard-al-Hasnah, which were discussed in Chapter 7.

2. An Islamic finance company must prove itself as being just as efficient as traditional banks as regards the provision of essential services.
3. It is imperative that Islamic finance companies heavily advertise their operational activities and the various types of services that they intend to offer. This is important since the public, both Muslim and non-Muslim, are aware of the operative procedures of conventional banks, simply because these banks have been in existence for hundreds of years whilst Islamic

banking is just about two decades old. The operative mechanics of these banks are alien to the public. The finance company should therefore inform the community via television, radio, and through the publication of prospectuses and magazines about the manner in which it conducts its activities. Islamic banks are currently engaged in inter-industry competition with interest-based banks. The latter are already offering Islamic financial products and the competition is likely to grow.

4. An Islamic finance company should invite leading Islamic bankers both from the Middle East and the West for meaningful dialogues with a view to solving problems that may possibly hinder the progress of Islamic banking. Leading personalities from the conventional banks as well as Reserve Bank officials should be invited to take part in such conferences or seminars so as to facilitate a greater degree of cooperation between conventional and Islamic banks.
5. An Islamic financing enterprise must ensure that a comprehensive and effective Sharia governance framework is in place for proper conduct of Islamic banking operations in accordance with Sharia principles.
6. South African universities should lay more emphasis on the teaching of Islamic economics in all its disciplines and should encourage the establishment of institutes which undertake research about Islamic economics.
7. Local students or employees should be sent to the Middle East with a view to gaining practical experience in Islamic banking.
8. Islamic finance companies will have to stay away from financing any un-Islamic activities. If at any point in time depositors come to know that the bank is financing unlawful activities, they will lose confidence in the bank

which will in effect trigger deposit withdrawal and probably lead to collapse of the bank.

9. It is imperative that an Islamic financing enterprise contributes to the social welfare of the community; they should show that they are generally concerned about the welfare of people by uplifting and setting up in life those people who have the skills and expertise for business but lack capital.
10. Islamic enterprises must also be marketed amongst the members of the non-Muslim community by employing non-Muslim public relation officers whose main duty will be to inform the non-Muslim community of the type of services that are being offered by Islamic institutions.
11. There is an urgent need on the part of the Islamic finance enterprise to devise interest-free monetary instruments enabling such enterprise to invest their excess liquidity in overnight markets free of interest.
12. The Islamic enterprise must attempt to employ committed and honest Muslim staff and train them by religious and practical lectures related to Islamic banking.
13. A greater deal of cooperation is needed between conventional banks and Islamic finance companies. Conventional banks should assist Islamic finance companies in developing interest-free instruments and products.
14. Government should also assist Islamic enterprises to develop by exempting them from certain legal requirement thus enabling them to operate until such legislation is adopted as might regulate their activities.

15. The Islamic Banking Supervisory Board should safeguard the interests of the Islamic banking institutions and the communities they serve by providing continuous surveillance and monitoring of up-to-date information on the underlying business activities financed by Islamic banking institutions.
16. Personnel appointed to serve on the board must be fit and proper to hold the position as board representatives, taking into account the following:
  - a. Probity, diligence and competence
  - b. Reputation, character, integrity and honesty
  - c. A clean criminal record

#### **8.4 SUGGESTIONS FOR FURTHER RESEARCH**

In view of the findings arrived at in this study, the following suggestions for further research are put forward:

1. As Islamic banking is gaining prominence there are new challenges that are coming continuously to the fore, like the redrafting of the rules for international trade and accommodating Sharia-compliant foreign trade financing. A good deal of research has been done in this field, but a lot more is needed.
2. Most of the present-day efforts in Islamic banking seem to be on the financing side. Matters relating to the liability side of Islamic banking seem to become an issue of growing importance in future; hence a greater research effort is required in this field.
3. There exists a great need to develop Islamic techniques of risk management and to ensure that such new techniques are free from the ills from which conventional methods are suffering.

4. There is an urgent need on the part of the Islamic banks to devise interest-free monetary instruments which would enable banks to invest their excess liquidity in overnight markets free of interest.
5. Conventional interest-based banks today are offering Islamic financial products and therefore studies will have to be undertaken to determine the impact of inter-industry competition from interest-based banks.
6. The progress of Islamic banking will depend on its ability to innovate financial instruments yielding stable income flows for orphans, widows, pensioners and other weaker segments of society, as well as financial instruments for meeting government's financing needs and formulas for the pricing of Islamic financial products.

## **8.5 CONCLUSION**

In Chapter 1 the primary objective of the study was stated as investigating the feasibility of the establishment of an Islamic banking enterprise in the greater Tshwane area in respect of its long term survival. The aim of this section is to render a conclusion and to determine whether the objective of the study has been achieved.

The study consisted of a literature study and an empirical research component. The literature study was undertaken on the relevant subject of the study securing information from textbooks, journals, magazines, newspapers and the internet so as to provide a better insight into the research problem and gain the necessary background to guide the empirical study. The empirical study was undertaken to provide the practical basis and corroborate the information gained from the literary study so as to ensure that a reasonably accurate version of the problems and challenges experienced by Muslim business people was given that measured up to the purposes of the study.

The study findings revealed that banks play a pivotal role in the facilitating of business transactions in society. The respondents of this study indicated that they would totally refrain from supporting interest-based banks, if some other viable alternative mode of banking that would serve their needs and comply with Islamic edicts were available. Also of pivotal importance to the respondents was the fact that the bank should be controlled and managed by devout and honest Muslims.

It emerged from the study that to successfully launch an Islamic bank in the long term it was imperative that the Banks Act as well as Reserve Bank rules and regulations be amended so as to cater for a profit and loss sharing system. Compliance with Basel III regulations would also be imperative.

It is highly unlikely that the above aforementioned requirements will materialise in the short term. Therefore, as an alternative, the viewpoint is advanced that it would be easier to establish a finance company that would provide essential banking services on the basis of Islamic Sharia and that at the same time could operate outside banking rules. This would be a much more viable alternative since the finance company would be able to operate without being labelled a bank.

The secondary objectives that were highlighted in Chapter 1 also seem to have been achieved, as it was stated that the financial crisis that is burdening the whole world mainly resulted from interest participation and that an Islamic bank abstaining from such participation could in fact resolve much of the financial problems that humankind is currently facing. It has also come to the fore that modern banking has its roots in interest-based dealings in which money is bought and sold at a price, and if left uncontrolled this would adversely impact on the economy. It has also emerged from both the literary and empirical study that Islam considers dealings in interest as violating divine injunctions and is calling on the wrath of Allah to befall those who continue in their interest-based dealings.

It could very well be that the financial crisis which has hit the whole world will serve as an eye-opener for humankind to desist from interest-based transactions; however, it is left to mankind to take heed. Also noteworthy is the fact that the Al Baraka Bank in South Africa is complying with Islamic principles but is operating under difficult constraints where the banking legislation as such mainly supports interest-based banks and hence the Islamic bank loses its competitive edge vis à vis the interest-based banks.

The final conclusion that could be drawn from the study would be that the establishment of an Islamic bank in the greater Tshwane area is feasible if it is structured along the lines of a finance company operating outside the laws and regulations applicable to a conventional bank.

Therefore it can be said that the objective of this study has been successfully achieved.

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