Frequently Asked Questions

Q1) What is Islamic banking?

Islamic banking is a banking system which provides banking services and products in line with the rules and principles of Shari'a, and is conducted under direct supervision and guidance of Shari'a scholars who act as advisors or members of the Shari'a boards of Islamic banks.

Q2) What are the Basic Features of Islamic Banking, and how are Islamic banks different from Conventional Banks?

Islamic banks are different from conventional banks in their core activities, since they can enter only into Shari'a compliant transactions, as opposed to conventional banks. Islamic Banks are prohibited from entering into any interest based transactions or any transactions whose terms and conditions are not in conformity with the principles of Shari'a. In contrast, a conventional bank would face no such restrictions in financing any transaction.

Islamic banking products are different from their conventional counterparts in both substance and nature. Most products of conventional banks are based on a single structure (a loan with interest), while those of Islamic banks are based on a variety of different Shari'a compliant contracts.

Islamic Banks are prohibited from transactions that are not Shari'a compliant such as:

- Sale and purchase of debt;
- Futures
- Sale of assets before getting title and possession thereof; and
- Financing of goods and activities prohibited by Shari'a.

Q3) What is the interest charged by conventional banks considered by Shari'a?

Interest charged by conventional banks, which is rent of money or the time value of money, is considered a form of Riba prohibited by Shari'a. This is because Riba al Nasee'ah (ربا النسيئة) or interest is the additional amount charged by a creditor in lieu of the time that he gives to the borrower for repayment of his principal loan amount, irrespective of the purpose for which the loan is extended, and the rate of interest being charged.

Q4) How do Islamic Banks ensure Shari'a Compliance?

To ensure Shari'a Compliance in all their financial activities and products, Islamic banks take the following measures:

- Develop a comprehensive system to ensure Shari'a compliance at all levels.
- Acquire the services of qualified and experienced Shari'a scholars and constitute a Shari'a Board (SB) to supervise all the activities.
- The SB is assisted by a properly staffed Shari'a Compliance Department in which experienced Islamic bankers with adequate Shari'a knowledge are appointed.
- All the products of the bank have to be approved by the Shari'a Board.
- Through Shari'a training, the requirements of Islamic banking transactions and the processes and execution details are explained to the staff to enable them to implement the transactions in a fully Shari'a compliant way.
- To ensure that all the instructions and fatawa of the Shari'a Board have been complied with, Islamic Banks conduct internal and external Shari'a audit of their transactions regularly, and ensure implementation of corrective measures, where required.
- Moreover, State Bank of Pakistan, through its inspections, ensures that Islamic Banks adhere to the rules and regulations issued by the SBP for Islamic banks and may penalize the banks for any irregularity.

Q5) On what basis do Islamic banks receive funds from Investment Depositors?

An Investment Depositor in an Islamic Bank, in his capacity as the fund provider (called Rabb ul Mal in Fiqh terminology) authorizes the Bank acting as the investment manager (called Mudarib in Fiqh terminology) to invest the Account Holder's funds on the basis of an unrestricted Mudaraba agreement in line with rules and principles of Shari'a.

The Mudarib contributes by providing his services and skills in investing and managing these funds. Both the parties share the profit as per the agreed ratio, while the losses, if any, are borne by the Rabb ul Mal, unless the loss has been caused due to breach of trust by the Mudarib i.e. misconduct, negligence or violation of the terms and conditions of the Mudaraba Agreement, in which case the loss has to be borne by the negligent Mudarib.

Q6) What is the basis of the Current Accounts in Islamic Banks?

Current Account provides the facility to customers to deposit their money in Islamic Banks for safekeeping with the condition that the amount shall be returned to them on demand. However, Islamic Banks are allowed to invest, at their own risk, the funds in the Current Accounts in Shari'a compliant transactions. Based on the principle of Al-Kharaj bed Dhaman (الخراج بالضمان), which means that entitlement to the profit of an investment is due to the risk taken, the profit or loss of any deployment of the funds in the current accounts would be for the account of the Bank, and the depositors shall be neither entitled to the investment profit nor shall they bear any loss. Therefore the funds in these accounts are guaranteed, and are considered as loans.

Q7) How do Islamic Banks invest their Funds?

The Islamic banks enter into different Shari'a-compliant trade and investment contracts to earn profit, some of which are listed below:

1. *Mudaraba* – مضاربة

It is an investment contract for an agreed period of time, in which one party (Rab ul-Mal **رب المال**) contributes capital while the other party (Mudarib - **مضارب**) makes efforts and the expected profit is shared as per the pre-agreed percentages, but the loss, if any, is borne only by the investor (Rab ul-Mal), unless caused by negligence or violation of terms of the contract by the Mudarib.

***2. Musharaka* - مشاركة**

- **Musharaka** means *partnership in business in order to earn a profit, if any, as per the agreed formula amongst the partners and to share the loss, if any, according to their proportionate share in the Musharaka.* Profit sharing ratio between partners must be pre-determined, which is not necessarily linked to their equity contribution ratio. However, loss shall be always borne by the partners pro-rata.

- **Diminishing Musharaka**: it is a form of co-ownership or partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him.

- A Diminishing Musharaka may be based on business partnership or on mere co-ownership of an asset, and in the latter case the bank leases its share of the asset to the co-owner and gets a purchase undertaking from the co-owner/lessee to buy out the Bank's share gradually.

***3.* Murabaha – مرابحة**

- It is a sale contract in which a seller sells his asset at ***disclosed cost*** plus an agreed profit. The sale price could be paid on spot or deferred to be paid in lump sum or in installments.

- An Islamic bank has to acquire the asset desired by a customer of the bank from a third party on cash payment, and then sell the same, through Murabaha, to its customer against a deferred payment.

- The bank may appoint the customer as the buying agent for the asset, but this role has to be clearly kept independent from the role of customer as the ultimate buyer of the asset.

***4. Istisna'* – استصناع**

'Istisna' is a sale contract in which the buyer purchases from the seller (the would-be manufacturer), fully described assets/goods which the seller undertakes to produce and deliver from raw material of his own, on a specified future date, against an agreed consideration.'

In other words, it is an order to a manufacturer to manufacture a specific commodity for the purchaser, and the price is fixed beforehand with the consent of all the parties involved. The price may be paid upfront or through installments in line with the progression of the work or at the time of delivery of the asset by the manufacturer.

***5. SALAM* - سلم**

It is a sale contract in which fully described goods to be delivered by the seller to the buyer at an agreed date in future are sold against spot payment. Salam is commonly used for financing purchase of agricultural produce.

6. ***Lease Contracts***

i. ***Ijara* (اجارة) – of Assets**

Ijara of Assets (اعيان) is *'leasing of a property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is sold for a specified period in return for a specified permissible consideration'.*

ii. Ijara Muntahiya Bit Tamleek (Ijara MBT) – اجارة منتهية بالتمليك

Ijara MBT is a lease contract that is accompanied by a separate promise from the lessor to transfer, through gift or sale for an agreed price, to the lessee the title of the leased asset at the successful end of the lease term or by stages during the term of the lease.

iii. Musharaka cum Ijara

- It is a combination of two contracts namely Musharaka and Ijara.
- As per this product, the Bank and the Customer enter into a Musharaka (partnership) to purchase an Asset (Home/Auto) and then the Bank leases its share to the Customer for a pre-specified term through an "Ijara/Lease Agreement".
- Once the Lease Agreement is signed between the partners, the Musharaka becomes non-operative and the relationship between the two partners, in principle, changes to that of a lessor and lessee with all its implications and consequences.

Q8) Is it permissible for an Islamic bank to impose penalty for late payment of Ijara or Murabaha installments, and how is it different from Riba?

In an ideal Islamic society, a creditor would not need to stipulate such a condition as people would pay their liabilities as a religious obligation; and a small element that would like to default and delay payments would be dealt with through effective courts and law enforcing agencies. However, in the absence of such an environment, if Islamic banks do not impose any penalties on late payment, some customers may not pay their liabilities. This might result in an increase in defaults, and thus Islamic banks may not be able to run their business efficiently and provide their investors with the desired return or any return at all.

Therefore, Islamic banks are allowed to take an irrevocable undertaking from each of its clients that in case of delay in payment of any liabilities, he/she will donate a specified amount to a charity fund supervised by the Shari'a Board of the Bank in a manner that is totally independent from the affairs of the bank. This amount paid by a defaulting customer is a donation by the customer (and not a penalty), for a charitable cause and the welfare of the society. These donations are not Riba because the Islamic banks (the creditors in this case), do not, and cannot, consider these donations as their income, nor can they derive any benefit out of them directly or indirectly, as they cannot use them even for the benefit of their staff. They incorporate such provisions in their contracts only in order to be able to use them as a tool for effectively pressurizing solvent defaulters to pay their liabilities in time.

Q9) Can a conventional Bank launch an Islamic branch/window?

Yes, a conventional bank can offer Islamic banking services provided it fulfills the following pre-requisites:

a. Establishes a Shari'a Board to guide it in relation to the Islamic banking operations, and ensure that all its products, contracts and systems are prepared under strict Shari'a supervision.
b. Prepares a separate balance sheet/financial statement for its Islamic banking operations, and makes comprehensive arrangements to keep all the funds, books, records, products and transactions of its Islamic banking operations independent and fully segregated from those of its conventional banking operations.
c. Establishes a well-staffed Shari'a Compliance Department and develops an effective Shari'a compliance mechanism;
d. Develops Shari'a compliant products and services;
e. Builds a team of Islamic banking professionals to manage all areas of Islamic banking;
f. Acquires systems and software that ensure Shari'a compliance;
g. Provides its staff with adequate Shari'a training or hires trained Islamic bankers;

h. Conducts Shari'a audits and reviews regularly.

Q10) Is there any difference between Interest and Usury?

No, in Islamic texts, we have the word Riba for this kind of contract which denotes that both these terms are regarded as one thing. The Qur'an and Sunnah do not differentiate between usury and interest; and the Fuqaha (فقهاء) throughout the ages have considered any increase (whether stipulated or on the basis of an established custom) in the repayment amount of a loan, irrespective of the rate of increase or the purpose for which the loan is extended, as Riba prohibited by Shari'a.

Q11) Is Islamic banking difficult and complicated? Does it involve a lot of documentation?

No, Islamic banking is neither difficult nor complicated. Islamic Banks have simple Islamic contracts like Murabaha, Ijara, Salam, Musharaka etc. However, since there are different kinds of products and arrangements, different sets of documents are required for each kind of product. Further, some of the documents are not required by Shari'a, but constitute part of documentation as ancillary documents for security purposes which are required to make the transaction legally enforceable in accordance with the laws and regulations of the country in which the transaction is executed. Islamic banking may be considered different or a bit difficult only because people are not familiar with the same; however once they get accustomed to it, they will not find any difficulty.

Q12) Is it possible to forecast profit rate?

It is not possible to forecast exact rate of profit, even in the most organized businesses; and no Islamic bank forecasts its profits. However, Islamic banks declare the profit of their investment pools periodically, and the declared rates can be referred to in order to show their past performance and provide an indication about their future performance. However, the Islamic banks should always add a disclaimer that they may or may not perform similarly in future.

Q13) Would you extend Islamic banking facilities to customers involved in businesses/activities prohibited in Islam?

No, Islam does not allow entering into, or any involvement, in prohibited transactions. This is one of the major differences between an Islamic bank and a conventional one.

Q14) Under the terms of Mudaraba, the investor/depositor is entitled to profits and has to bear the losses. Why do Islamic Banks never share their losses with customers in spite of having overall losses in their financial statements?

The possibility of a loss in such a properly organized and regulated banking sector is very low, because banks enter into very low-risk transactions and apply various risk mitigating tools to minimize chances of losses. Further, the investment portfolios of these banks are diversified enough to be able to absorb a good portion of the losses; and as such in most cases, there could be a possibility of lower than expected profit rather than incurring a loss.

Q15) Is insurance allowed in Islam?

Conventional insurance is NOT allowed in Islam because it entails Riba, Gharar (uncertainty) and gambling. That is why Shari'a scholars have provided a Shari'a compliant alternative. The Shari'a compliant insurance system, based on the principle of Takaful, which means collaboration and joint shouldering of risks amongst a group of people, has been launched successfully in Pakistan and other countries.

Q16) What are the basic principles of Takaful and how is Takaful different from conventional insurance?

Takaful is the Islamic way of Insurance. Takaful means mutual protection and joint risk-sharing through voluntary contributions/donations by each member; while the Takaful operating company acts as an agent of the policy holders and not as insurer.

Takaful has many modes, one of which is called the Waqf model. It eliminates the elements of Riba, chance, gambling and ambiguity by the following ways:

a. Since Takaful is based on donations; and is not a contract of sale/purchase, the possibility of its leading to Riba is eliminated.

b. Ambiguity in an act of *Tabarru'* (donation) is forgiven, as it does not lead to any dispute or deprivation of any party from his rights.

c. The participants get benefit from the *Waqf* pool as per the terms and conditions of the *Waqf* Deed which designates them as beneficiaries of the *Waqf* pool.

d. The participants are investors and they share the profit of their investment in the investment pool; and the Takaful company invests the deposit pool in only Shari'a compliant products.

e. A Takaful Company manages the Takaful Fund on *Wakala* or *Mudaraba* basis.

Q17) Do Islamic banks offer loans?

Islamic banks do not offer loans, because any premium/additional amount over and above the loan amount is tantamount to Riba. Islamic banks offer financing through Shari'a compliant modes of sale and purchase and apply various ways of investment, as mentioned in our responses above.