easily foresee an increase in the scope of economic activity and greater financial discipline in the economy.

2. At present all costs—those attributed to time lag in a deferred payment, default risk and the exchange rate risk—are covered under the interest rate and margins added to it. Such costs are not likely to disappear in an Islamic *riba*-free framework. However, the via media to address these costs will be different.

3. At the moment bank financing is restricted mostly to big parties and medium-to large-size projects. In the Islamic framework, the financial institutions will also face the pressure to generate quick turnover and profit flows in order to attract deposits. This will force the management of IFIs to go out and approach small- and medium-size businesses. This will, in turn, increase the prospects for modarabah and musharakah—participatory—financing.

Finally, it needs to be made clear that good moral fabric of the society is as much important for the Islamic financial system as it is for the existing *riba*-based system. The Islamic system does not need special moral uplift of the society prior to its enforcement. It can establish itself on purely economic grounds—even against competition form a *ribawi* system. It does not require government protection in the traditional sense. It depends on the government support to the extent of provision a proper regulatory framework.

musharakah modes, *Shirakah almutanaqisah* is an attractive option.

Equity Purchases by Private Investors

Trading instruments can be used for this purpose. The transactions would represent sale and purchase of ownership rights.

Agricultural Financing

All the above-mentioned trading modes can replace the existing agricultural credit, with due regard for the Shari`ah A`hkam on *ba`ey mo'ajjal* and *ba`ey salam*. Modarabah and musharakah can also be adopted for agricultural financing under the acronym of *muzara`ah*.

In addition to the above, banks can provide funds transfer services for a fee, payments services for a charge in L/C arrangements, float special modarabahs, etc. The possibilities are endless. The only caveat is that one has to ward against *riba* creeping through the back-door.

In short, one cannot think of any practical need for which there is no Islamic option for materializing it. The essential differences from the existing commercial banking are as follows.

1. At present banks are doing money-to-money transactions. They issue loans to customers. Although they do some appraisal of every application, they are least concerned with what the customer actually does with the money borrowed. On the other hand, IFIs will either provide finance on a participatory basis—as in modarabah or musharakah—or link financing directly to an economic transaction—in the instance of trading. In other words, IFIs will not be 'financiers' in the traditional sense; they will act as 'entrepreneurs' or 'traders'. These arrangements will serve as restraints on the present-day investors and industrialists who thrive on loans. One can

a) The Shari`ah conditions for such contracts, in particular, the safeguards against *riba,* have to be observed.
b) Once the amount due against the customer in a contract is fixed, it becomes a "loan" against the customer, and the rules for loan contracts shall apply on it.
c) Banks can determine the profit they charge in such contracts by taking into account their costs, market conditions and even time period in the honouring of the contract at the customer`s end. There is no Shari`ah restriction on the amount of profits that the bank may seek. Of course, the customer too has the option of not entering into the contract.

Project Financing

Banks can do multiple trading contracts with the concerned party, where each contract may cover one item in the project. Alternatively, banks can enter into modarabah or musharakah contracts with sound parties. In a musharakah arrangement, the bank does not need to entangle itself into day-to-day running of the project. The bank may simply choose to provide accounting, auditing, taxation and/or banking services to the customer. In the provision of such services, however, valuation of the bank's services ought to be at cost to the bank, not at market prices. This will be necessary to close any back-doors for *riba*.

Working Capital Financing

This can be done either on modarabah or musharakah basis with the profit-sharing ratio suitably taking care of the concerned parties` financial stake in the context of the entire project and their bargaining positions. Some novel arrangements such as banks directly paying to workers and charging to the business (on a deferred payment basis) are also conceivable.

Home Financing

Apart form the standard trading and

Mobilization of Savings in Private Hands

Current Accounts (carrying no return for depositors) may be recorded as banks' loans from the depositors. This will ensure safe return to depositors, and at the same time allow banks to use the idle funds.

Savings accounts can be replaced by modarabahs between the bank and depositors. There can be a general modarabah form prescribed for this purpose, including the formula for distribution among the depositors of the depositors' share in bank profits. The following restrictions need to be observed:

a) The profit-ratio in favour of the depositors (as a group) should be announced in advance. This may be done at the beginning of the accounting year.

b) These deposits should be administered separately to avoid the problem in determining the incidence of a loss.

c) Funds in these deposits should be used in ventures where cash flows and returns are realized in a relatively short span of time.

Time (or Term) deposits may be handled in a way similar to savings deposits.

The adoption of modarabah mode for mobilization of funds may necessitate new approaches to defining costs and equity appraisal for the banks. For example, treatment of bank directors' salaries as cost is questionable.

Profitable Application of Funds by Islamic Financial Institutions Trading:

A host of customer needs, whether for consumption or f commercial purposes, can be fulfilled through *ba`ey mo'a* (sale on deferred payment—in lump sum or instalments) a *ba`ey salam* (sale with advance payment for later delivery). In this regard, the following points may be noted:

The modarabah versus musharakah choice by an IFI will depend on how much commitment the institution is willing to make to the running of an enterprise. The contract can be for a single transaction or more. Similarly, it may be a one-period, multi-period or a perpetual arrangement.

Within the general framework of the above-mentioned transactions, there is room for defining new modes which offer attractive payments and receipts prospects for the concerned parties, subject to the requirements of no *riba*, no *ghararr*, etc. These may include *shirakah al-mutanaaisah* (decreasing participation), etc.

Let us note that there is a room for IFIs to seek suitable guarantees for backing up their credit operations. Shari'ah guidelines in this regard may be found in Ayah 282 of Surah *alBaqarah,* the A'hadith on *rehn* (pawning) and the *rehn* chapter in books of Fiqh. Safeguards against cheating in modarabah contracts may be ensured through auditors, with the interested party meeting the auditing costs out of its share of profits. Islamic financial Institutions can also learn from the experience of the *Gharimeen Bank* of Bangladesh to reduce the risk of customer default.

Pure loaning can be feasible only if economic considerations justify it. Practically it should be considered out of question for institutions whose *raison d'etre* is profits.

In passing, we may also mention that *Ijarah* (leasing) or *Ijarah wa iqtina* (hire-purchase) are other recommended modes of transaction for IFIs. But, quite frankly, there is a need for a careful review of their permissibility at an "institutional level". Such a need stems from the fact that in A`hadith many combinations of otherwise permissible transactions are prohibited because they give rise to the possibility of *riba*.

In the light of our definition of *riba,* permissible contracts and other points mentioned above, we can now seek the implications for the present age.

A musharakah differs from a modarabah in just one respect: Both contracting parties share in the provisions of resources as well as the effort to run the joint venture. Notwithstanding this difference, the general rules for a musharakah contract are the same as those for a modarabah, namely, advance fixation of the profit-sharing ratios but sharing of losses in proportion to one's equity stake. However, there is no Shari'ah restriction that the profit-sharing ratio must be related to a party's equity share.

In the case of a credit sale or purchase, the Islamic financial institution (IFI) has to play the role of a trader, not that of the traditional financier. In this regard, the general principles stated in Ayah 282 of Surah *alBaqarah* and other A`hkam in A`hadith on trading ought be observed. These include documentation, avoidance of *riba* and *ghararr*, fair trading practices, and so on. However, it is not essential for IFIs to maintain stocks of merchandise for their trading operations as long as the Shari'ah criteria for transfer of ownership to the institution is observed in the transaction process.

If the contract between two parties is fundamentally a loan contract, it has to be executed on a one-for-one and even basis. The only exception to this general rule is that the lender can claim documentation coasts as per Ayah 282 of Surah *alBaqarah*. It is worthwhile to note that "documentation costs" is a much narrower concept that the commonly understood "services charges". The latter is devoid of Shari'ah support; in fact, it is, in a sense, a back-door for *riba*.

On the practical plane, if an IFI is ready to take entrepreneurial risk and the other party is willing to share ownership, permissible modes of transaction are modarabah or musharakah. If not, the relevant permissible mode of transaction is either credit sale or credit purchase, with the financial institution acting as a trader.

In modern times, complex institutions and sophisticated instruments have been devised to serve practical needs of those who own funds and those who need them. But the basic nature of transactions has not changed since the revelation of the original A`hkam (injunctions) of *Shari`ah*. People are still producers and consumers of goods, on one hand, and suppliers and buyers of resources, on the other. They finance their transaction needs either themselves or with funds obtained from others. Funds are acquired through borrowing (loaning) or under participatory (equity) arrangements. Only the instruments have become more complex today.

Before getting down to the specifics, let us note a few general points which have support from the Qur'an and Sunnah. The Islamic options to facilitate existing needs can be broadly defined as follows.

- A. **Participatory financing—profit—loss sharing arrangements like *modarabah* and *musharakah***
- B. **Credit sales, such as *ba`ey mo'ajjal* (sale on deferred payment) or *ba`ey salam* (sale on cash payment for future delivery)**
- C. **Loaning, but on a one-to-one and equal basis**

A modarabah contract is essentially a special type of arrangement between a party offering labour and another owing resources (capital). In fact, it is an alternative to a wage contract between the tow parties. While the latter contract gives rise to an employer-employee relationship, the former entails joint ownership of the enterprise. The fundamental difference between the two arrangements, therefore, lies in their legal implications. On the analogy of prior fixation of the wage rate in an employer-employee contract, advance fixation of the profit-sharing ratio for each party is a pre-requisite for a modarabah contract. In the case of a loss, however, the party contributing effort is not compensated for its labour and the financier loses his capital.

RIBA - FREE ALTERNATIVES FOR MODERN BANKING

Sayyid Tahir[1]

According to the Qur'an and Sunnah, *riba* is a discrepancy which results from the contractual obligations of a party in a direct exchange of items of the same general kind (such as a loan transaction). "Interest" or "interest rate" in a capitalist economy fits into this description. Therefore, the elimination of *riba* is synonymous with the elimination of interest in the modern age.

Interest rate is the linchpin of all modern economies. It is the medium which regulates the basic functions of mobilization of financial resources and their efficient allocation among competing uses. Virtually all individuals, businesses, banks and other financial institutions and governments are dependent on interest-based instruments for their needs——both domestically and internationally. It is, therefore, not surprising that the some quarters fear the collapse of a modern economy with the elimination of interest.

Let us remember that when *Allah Sub`hanahu wa Ta`aala* prohibited *riba*, He did not shut doors on man's pursuit of economic gains. Indeed, He prescribed an alternative system which is practical, flexible and the best to serve the needs of mankind for all times to come. Elimination of *riba*, therefore, does not mean a move towards a standstill, not to mention retrogression. If one takes a closer look at the Islamic financial system, without any preconceived notions, all apprehensions turn out to be baseless.

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