

The Bank of Khyber Islamic Banking Group Shariah Department

Frequently Asked Questions On Islamic Banking.

What is Islamic banking?

It is a banking system which provides banking services and products in line with the rules and principles of Shariah and is conducted under direct supervision and audit of Shariah scholars. Islamic banking is defined as banking system which is in consonance with. Interest free banking is a narrow concept denoting a number of banking instruments or operations which avoid interest. Islamic banking, the more general term, is based not only to avoid interest-based transactions prohibited in Islamic Shariah but also to avoid unethical and un-social practices. In practical sense, Islamic Banking is the transformation of conventional money lending into transactions based on tangible assets and real services. The model of Islamic banking system leads towards the achievement of a system which helps achieve economic prosperity.

What is Interest / Riba?

Interest/Riba is rent of money or the time value of money. It is the additional amount charged by a creditor in lieu of the time that he gives to the borrower for repayment or delay in payment.

Is there any difference between Interest and Usury?

No, both have the same meaning. Quran, Sunnah and Fiqh do not differentiate between the two. Islam terms what is known as interest or usury as Riba and therefore prohibits it. The origination of term interest dates back to 17th century with the emergence of banking system at global level. Interest means giving and/or taking of any excess amount in exchange of a loan or on debt. Hence, it carries the same meaning/value as that of Riba.

What are the sayings / Ahadith about Riba/Interest?

According to Islamic jurists and scholars, there are around 40 different Ahadith on the subject of Riba and its prohibition from Holy Prophet (peace be upon him).

Few of these are as follows:

1. From Hazrat Jabir (May Allah be pleased with him): The Prophet, cursed the receiver and the payer of interest, the one who records it and the other who witness to the transaction and said: "They are all alike [in guilt]." (Narrated in Muslim, Kitab al-Musaqat, Bab lani akili al-riba wa mukilihi; also in Tirmidhi and Musnad Ahmad)
2. From Hazrat Abdallah ibn Hanzalah (May Allah be pleased with him): The Prophet, said: "A dirham of riba which a man receives knowingly is worse

than committing adultery thirty-six times" (Narrated in Mishkat al-Masabih, Kitab al-Buyu, Bab al-riba, on the authority of Ahmad and Daraqutni)

3. From Hazrat Abu Hurayrah (May Allah be pleased with him): The Prophet said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest." (Narrated in Ibn Majah, Kitab al-Tijarat, Bab al-taghlizi fi al-riba; also in Musnad Ahmad)
4. From Hazrat Abu Hurayrah (May Allah be pleased with him): The Prophet said: "Riba has seventy segments, the least severe being equivalent to a man committing adultery with his own mother." (Narrated in Ibn Majah)

Does interest/Riba relate only to consumption loans or it applies to commercial loans also?

The interest is prohibited whether it is consumption loan (loan for meeting day to day human needs) or commercial loan (loan for business purpose). There are quite a number of Ahadith which clarify that in the days of Holy prophet, people not only borrowed for consumption purposes but also for productive purposes. Few of the Ahadith are given below for reference:

- (i) Ibn Saad has reported Hazrat Umar (Radi-Allahu anhu), wanted to send a trade caravan to Syriya. He borrowed four thousand dirhams from Sayyidna Abdurrahman ibn Awaf, Radi-Allahu anhu for this purpose. (Ibn Saad, Al-Tabqat al-Kubra, Beirut, V.3, P.278)
- (ii) Ibn Jarrir has reported that Hind, daughter of Utbah and wife of Abu Sufyan borrowed four thousand dirhams from Sayyidna Umar, Radi-Allahu anhu, for the purpose of her trade. She invested this money in purchasing goods and selling them in the market of the tribe of Kalb. This is an ample testimony that the commercial loan was in practice when Quranic verses on Riba were revealed and the term Riba covers not only consumption loan but also the commercial loan. (Al-Tabari, Tarikh-al-Umam V.3, P.87, Events of the year 23 A.H)

Can a conventional bank, having interest-based products and services, also offer Shariah compliant financial services?

Islamic law (Shariah) does not require that the seller of a product be Muslim, or that its other services be Shariah compliant as well. As long as the product offering is Shariah compliant, the provider can be a bank committed to providing a full array of banking services.

Do We Really Need Islamic Banks?

The question may be divided into following two parts for proper understanding:

1. Do we need bank?
2. If yes, why it should be on the basis of Islamic Shariah.
 - 1 Do we need bank?

In order to assess the need of the bank, we need to look at the functions it performs. In any society, be it a secular or Islamic one, the main function of the bank is to mobilize funds from the surplus units and allocate these to the shortfall units or to the units having budget

constraints. This function is performed through the process of financial intermediation in the financial markets where banks are the most important operators. Financial intermediation enhances the efficiency of the saving/investment process by eliminating the mismatches inherent in the requirements and availability of financial resources of savers and entrepreneurs in an economy. Normally the surplus units/savers are the small households or individuals who save relatively small amounts whereas the entrepreneurs are firms which often need relatively large amounts of funds. Financial intermediation removes this size mismatch by collecting the small savings and packaging them to suit the needs of entrepreneurs. In addition, entrepreneurs may require funds for periods relatively longer than would suit individual savers. Intermediaries resolve this mismatch of maturity and liquidity preferences again by pooling small funds. Moreover, the risk appetite of savers and entrepreneurs are also different. It is often considered that small savers are risk averse and prefer safer placements whereas entrepreneurs may wish to deploy funds even in risky projects. The role of the intermediary again becomes crucial. They can substantially reduce their own risks through the different techniques of proper risk assessment and risk management. Furthermore, small savers cannot efficiently gather information about opportunities to place their funds. Financial intermediaries are in a much better position to collect such information which is crucial for making a successful placement of funds. The role and functions of banks outlined above are indeed highly useful and socially desirable. Hence, we reach to the point where the banks become the need of any economy.

2 Why the bank should be on the basis of Islamic Shariah?

Commercial banks normally operate on lending basis. They may not be unduly much bothered about the use of funds as long as the borrower pays back the loan regularly. This does not ensure that the amount advanced to the borrower was used for the productive or unproductive purpose. Thus the impact of commercial banking on economic development may remain below potential. Whereas, Islamic bank provides finance which has a greater focus on the productive use. Islamic banks' financing targets both the equity as well as the working capital needs of enterprises. It is expected that its impact on economic development will be more pronounced. The avoidance of interest by Islamic banking is an additional plus. It is mentioned that allocating financial resources on a productive basis is more efficient than their allocation on a purely lending basis. It has also been argued that the whole banking system would be more stable and less liable to suffer from financial crises. A monetary system based on Riba is also unjust as it allows savers and banks to get away with interest (guaranteed fixed rate of return on their loans) without bearing a fair part of the risks faced by entrepreneurs.

Islamic bank's financing is sometime costlier than that of the conventional banking. Why is it so?

Islamic banking is in its early stage and is in the process of strengthening its base in the economies having conventional banking rooted deeply in the current interest-dominated system. The volume of business captured by the conventional banking system gives it an edge over Islamic banking in terms of cost due to its ability of having achieved economies of scale. The conventional banks can avail the economies of scale due to their wide network and huge volume of business which the Islamic banking, in its nascent stage cannot avail given the present volume of their business. Further, Islamic banking has to maintain some additional documentation which adds to the cost of its operations. While Islamic banking may appear to be marginally costlier at this stage, the incremental cost is not prohibitive in relation to the benefits.

The end result of Islamic Banking and Conventional Banking is the same. Why do they appear similar?

The validity of a transaction does not depend on the end result but rather the process and activities executed and the sequence thereof in reaching the end. If a transaction is done according to the rules of Islamic Shariah it is Halal even if the end result of the product may look similar to conventional banking product. For example a normal chicken burger in USA and Pakistan may look similar, smell similar and taste similar but the former is Haram and the later is Halal due to its compliance of Islamic guidelines of slaughtering animals.

Similarly, if a person is feeling hungry, he may steal a piece of bread and eat or alternatively buy a piece of bread to eat. The apparent end result would be same but one is permissible in Shariah and the other is not allowed. The same is also true for Islamic and conventional banking. Therefore, it can be concluded that it is the underlying transaction that makes something “Halal” (allowed) or “Haram” (prohibited) and not the apparent result itself. Apparently, Islamic banks may look similar to conventional banks, however the contracts and product structures used by Islamic banks are quite different from that of the conventional bank. In the verse 2:275 of the Holy Quran, Allah the Almighty has responded to the apparent similarity between trade and interest by resolutely informing that He has permitted trade and prohibited Riba (though they may look similar to someone).

Islamic banks use interest base system (KIBOR) as a Bench Mark while determining profit; how Islamic banking can be said to be Islamic?

Islamic banks should ideally have their own benchmark system for determination of profit. Since, the industry is in its initial stage of development, it is using the available benchmark for the banking industry. It is expected that once it is grown to a sizable level, it would have its own benchmark. However, using Interest Rate benchmark for determining the profit of any permissible transaction does not render the transaction as invalid or haram. It is the nature/mechanism of the transaction that determines its validity or otherwise. For example Mr. A and Mr. B are two neighbors. Mr. A sells liquor which is totally prohibited in Islam whereas Mr. B, being a practicing Muslim dislikes the business of Mr. A and starts the business of soft drinks. Mr. A wants his business to earn as much profit as Mr. A earns through trading in liquor. Therefore he decides that he will charge the same rate of profit from his customers as Mr. A charges over the sale of liquor. Thus he has tied up his rate of profit with the rate used by Mr. A in his prohibited business.

One may say that Mr. B uses an undesirable benchmark in determining the rate of profit, but obviously no one can say that the profit charged by him is haram because he has used the rate of profit of the business of liquor only as a benchmark. The same is true for Islamic banks, it is most desirable and preferable that Islamic bank develop their own benchmark however; in the absence of any such alternative, interest rate related benchmark can be used.

What are the basic principles of Islamic banking?

There are at least six basic principles which are taken into consideration while executing any Islamic banking transaction. These principles differentiate a financial transaction from a Riba/interest based transaction to an Islamic banking transaction.

1. Sanctity of contract: Before executing any Islamic banking transaction, the counter parties have to satisfy whether the transaction is halal (valid) in the eyes of Islamic Shariah. This means that Islamic bank's transaction must not

be invalid or voidable. An invalid contract is a contract, which by virtue of its nature is invalid according to Shariah rulings. Whereas a voidable contract is a contract, which by nature is valid, but some invalid components are inserted in the valid contract. Unless these invalid components are eliminated from the valid contract, the contract will remain voidable.

2. Risk sharing: Islamic jurists have drawn two principles from the saying of prophet Muhammad (SAW). These are “Alkhiraj Biddamaan and “Alghunun Bilghurum”. Both the principles have similar meanings that no profit can be earned from an asset or a capital unless ownership risks have been taken by the earner of that profit. Thus in every Islamic banking transaction, the Islamic financial institution and/or its deposit holder take(s) the risk of ownership of the tangible asset, real services or capital before earning any profit there from.
3. No Riba/interest: Islamic banks cannot involve in riba/interest related transactions. They cannot lend money to earn additional amount on it. However as stated in point No. 2 above, it earns profit by taking risk of tangible assets, real services or capital and passes on this profit/loss to its deposit holders who also take the risk of their capital.
4. Economic purpose/activity: Every Islamic banking transaction has certain economic purpose/activity. For example, Real Goods are required to be purchased under Murabaha and a real non consumable asset has to be there capable of producing a usufruct in case of Ijarah of assets. Further, Islamic banking transactions are backed by tangible asset or real service.
5. Fairness: Islamic banking inculcates fairness through its operations. Transactions based on dubious terms and conditions cannot become part of Islamic banking. All the terms and conditions embedded in the transactions are properly disclosed in the contract/agreement.
6. No invalid subject matter: While executing an Islamic banking transaction, it is ensured that no invalid subject matter or activity is financed by the Islamic financial transaction. Some subject matter or activities may be allowed by the law of the land but if the same are not allowed by Shariah, these can not be financed by an Islamic bank.

If Islamic banks do not invest in interest based activities then how do they generate profit to pay to their customers?

The Islamic bank uses its funds in various trades, investment and service related Shariah compliant activities and earns profit thereupon. The profit earned from such activities is passed on to the depositors according to the agreed terms.

How can BOK Islamic banking ensure that all the investments are in line with the pronouncements and directives of the Shariah Board?

All investments are first approved before signing the contracts by our Shariah Supervisory Board/Shariah Advisor. The Shariah auditors monitor the operations of the Bank and the implementation process. If they find any transaction implemented in a Shariah repugnant way, the Shariah Advisor advice to take away its return and give it away in charity.

What is different about IBG (BOK) as other banks are also offering the same services?

As far as comparison with the services provided by conventional banks are concerned, the main difference is that BOK Islamic Banking provides only Shariah compliant products and services and in no way enters into any Shariah repugnant and interest based transaction. BOK Islamic Banking is proud of its pioneering role of starting Islamic banking in government owned banks in Pakistan. Moreover BOK Islamic Banking has a full fledged Shariah Supervisory committee and a full time Shariah advisor, which are involved in structuring, documentation, vetting approval and post transaction audit of all transactions and products. The affairs of the Bank are supervised by a Fatwa and Shariah Supervisory Committee whose decisions are binding on the Bank in Shariah matter. The Shariah Committee is comprised of a number of internationally renowned Shariah scholars

Who determines that Islamic Banking of BOK Products are Shariah Compliant?

Care would be taken in ensuring that both the arrangements of accepting deposits from customers, and investing that amount in Islamic Modes of Financing, are done in a strictly Shariah-compliant manner. In this regard the BOK Shariah Supervisory Committee, an independent committee of qualified scholars of repute, approves all products offered by BOK Islamic Banking. A Shariah ruling (Fatwa) confirming the same can be provided on request. Currently, the members of this committee are:

- *Mufti Muhammad Zahid* *Chairman*
- *Syed Muhammad Abbass* *Member*
- *Dr. Dost Muhammad Khan* *Member*
- *Dr. Shahzad Iqbal Sham* *Member*
- *Mr. Muhammad Ayub* *Member*

Qazi Abdul Samad (Shariah Advisor)

Beside this BOK has full time Shariah Advisor to regularly reviews and appraises the BOK products.

What are the major modes of Islamic banking and finance?

Following are the most commonly used modes of Islamic banking and finance:

1. MUDHARABA
2. MUSHARAKA
3. MURABAHA
4. IJARAH
5. DIMINISHING MUSHARAKAH
6. SALAM
7. ISTISNA

What is Mudarabah?

A form of partnership where one party provides the funds while the other party provides expertise. The person who brings in the money is called "Rab-ul-Maal" while the management and work is an exclusive responsibility of the "Mudarib". The profit sharing ratio is determined at the time of entering into the Mudarabah agreement whereas in case of loss it is borne by the Rab-ul-Mal only

What is Musharakah?

Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. Under Islamic banking, it is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

What is Murabaha?

Murabaha is one of the most common modes used by Islamic Banks. It refers to a sale where the seller discloses the cost of the commodity and amount of profit charged. Therefore, Murabaha is not a loan given on interest rather it is a sale of a commodity at profit.

The mechanism of Murabaha is that the bank purchases the commodity as per requisition of the client and sells it to him on cost-plus-profit basis. Under this arrangement, the bank is bound to disclose cost and profit margin to the client. Therefore, the bank, rather than advancing money to a borrower, buys the goods from a third party and sells those goods to the customer on profit. To facilitate the customer the bank receives the amount in installments.

What is Musawamah?

Musawamah is a general and regular kind of sale in which price of the commodity to be traded is bargained between seller and the buyer without any reference to the price paid or cost incurred by the former.

What is Ijarah?

Ijarah refers to transferring the usufruct (the benefit that one can receive from an article/object/thing etc.) of an asset but not its ownership. Under Islamic banking, the bank

transfers the usufruct to another person for an agreed period at an agreed consideration. The asset under Ijarah should be valuable, non-perishable, non-consumable, identified and quantified. All those things which do not maintain their corpus during their use cannot become the subject matter of Ijarah, for instance money, wheat etc.

Note: the things that are finished with consumption like food items are consumable whereas the things that do not finish with consumption like machinery / motorcar are called non-consumable.

What is Bai Salam?

Salam means a contract in which advance payment is made for goods to be delivered at a future date. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quantity and quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute.

What is Istisna?

It is a specific kind of a Bai (sale) where the sale of the commodity is transacted before the commodity comes into existence. The legality of Istisna is accepted by the Shariah scholars because it does not contain any prohibition, As far as the financing mode, it has been legalized on the basis of the principles of Istihsan (public interest)

Does BOK Islamic Banking use the funds deposited in Islamic Accounts in a Shariah compliant manner?

Yes. Funds deposited in this account are used only in a Shariah compliant manner as per the guidelines of Shariah Supervisory Committee / Shariah Advisor and SBP instructions and guidelines.

How do BOK Islamic banking Savings Account and Term Account work?

Islamic Savings & Term Account operate on a well known Islamic financing mode of Musharakah. Under these products the Customers provides funds to the Bank for placement in Shariah compliant assets. The bank combines its own equity with these funds as per investment ratio and invests that in Shariah Compliant assets. The profit from the portfolio of Assets is shared between the parties as per an agreed ratio. The agreed ratio are displayed on website of BOK and communicated to Branches on a monthly basis to display on Notice Board.

Elements of Riba have been eliminated completely from the contracts so that income earned through investments in assets is completely halal and is shared by the depositors in a Shariah-compliant manner. A transparent system of weightages is used to calculate the profit rates on the basis of which profits are disbursed to each customer. These weightages are announced

by the bank at the beginning of each month/ term and posted on the Notice Boards of Islamic Banking Branch as well as on our website.

Can there be a loss in the Savings & Term Accounts?

In line with the principles of Musharakah if there is a loss in the overall portfolio of Islamic assets, the same will be passed on to the Customers in the exact ratio of their investment in the portfolio. However, it must be noted that BOK takes utmost care in extending financing to Customers and all transactions included in the portfolio of Islamic assets go through a rigorous credit and risk screening process

Who is eligible to open accounts in Islamic banks?

All persons (individuals, corporate entities, firms, societies, government organizations, statutory bodies/corporations, public and private institutions, etc.) are eligible to open account in Islamic banks provided they fulfill the banks' and the regulatory authorities' requirements.

How is the Customer's profit calculated?

Profit from the pool of Islamic assets is calculated at the end of every month. BOK keeps a share of the profit as per an agreed ratio (the agreed ratio for the each month is communicated to Branches on a monthly basis). The balance profit is distributed between various categories of Customers (such as Savings Account, 1 month, etc.) as per their respective weightage. The profit amount for each category is used to calculate the Profit rates for each category of Customers, which are announced at the end of the each month.

How would it be possible to forecast long term profit rate?

No one can forecast profits. Islamic banks declare the profit of their investment pools periodically, and the declared rates can be referred to show their past performance with a clear disclaimer that the bank may or may not perform similarly in future.

Is Islamic banking services offered to Muslims only?

No, Islam does not prohibit from selling or buying or entering into partnership with non-Muslims provided the underlying transactions are Shariah compliant.

Is insurance allowed in Islamic banking?

The form of Islamic insurance is TAKAFUL which is based on Sharia rules. In case of absence of a Takaful based company, Islamic banks are allowed to get insurance cover through conventional insurance to avoid exposing the investors' deposits to high risk.

What is Takaful?

Takaful is the Islamic way of Insurance. Takaful means mutual protection and joint guarantee through contribution by each member.

How is Takaful different from conventional insurance?

Takaful eliminates the element of chance, gambling and ambiguity by:

- a. investing the deposit pool in only Shariah compliant products.
- b. the participants are investors and they share the profit of their investment.
- c. A Takaful Company manages the Takaful Fund on Wakala or Mudarabah basis. At the same time they compensate those of the group who are exposed to losses.

Does Islamic bank offer loans?

Islamic banks do not offer loans; they offer financing through Sharia compliant modes of investment and transactions.

What are Sukuk?

Sukuk are Islamic Investments certificates issued against shares in the underlying assets, whether existing or described assets promised to be delivered in future, or shares in the usufruct (the benefit that one can receive from an article/object/thing etc) of such assets or shares in services.

What is meant by Shariah / Islamic Law?

Word Shariah means a way or path. In Islam Shariah refers to the divine guidance and laws given by the Holy Quran, the Hadith (sayings) of the Prophet Muhammad (Peace Be Upon Him) and supplemented by the juristic interpretations by Islamic scholars. Shariah embodies all aspects of the Islamic faith, including beliefs and practices. Islamic Shariah or the divine law of Islam is derived from the following four sources:

1. The Holy Quran
2. The Sunnah of the Holy Prophet (Peace Be Upon Him)
3. Ijma' (consensus of the Ummah)
4. Qiyas (Anology)

Is it permissible for an Islamic bank to impose penalty in case receivables are delayed?

In Islamic law it is permissible to penalize a debtor who is financially sound but willfully delays payment of debt without any genuine reason. Such act of the debtor is unjust as the Prophet (PBUH) has said,

"A rich debtor who delays payment of debt commits Zulm".

A heavy non-performing portfolio and default on the part of clients is a serious problem confronting the financial institutions all over the world including Pakistan. This problem may be a threat to the success of Islamic banking system if not properly addressed. If clients do not honour their commitments in respect of timely payment of a debt created in installment sale, Murabaha, leasing or do not pay banks' share of profit in participatory modes or do not deliver goods at stipulated time in Salam and Istisna, it could cause irreparable loss to the

system. The banks, financial institutions, depositors and ultimately the economy will have to suffer its consequences. The jurists allow punishment (T'azir) to such borrower in the form of fine. In view of the severity of the problem, Islamic Fiqh Academy of the OIC (Organization of Islamic Cooperation) and Shariat Appellate Bench of the Supreme Court of Pakistan have approved the provision of penalty clause in the contractual agreements. This would also help in maintaining a credit discipline in the banking and act as a deterrent against debts becoming bad or unrealizable. However, the penalty proceeds would be used for charity as penalty cannot become source of income for the bank in any manner.

Can Islamic banks claim compensation or liquidated damages on account of late payment/default by the clients?

The contemporary Shariah scholars have evolved a consensus that banks are authorized to impose late fees on the customers who willfully default in payments. However, the proceeds of such penalty are to be used for charity purposes. It is the court or any recognized alternative independent dispute resolution body which can allocate any part of the penalty as liquidated compensation / solatium for the banks. Liquidated damages can be given to banks in case of default on the part of banks' clients provided it is based on actual financial loss. The court or a recognized adjudicating forum may reasonably adjust the amount of compensation. The actual financial loss cannot be the loss in terms of conventional opportunity cost. It has to be proved by the bankers themselves to the satisfaction of the court or any arbitrator.

What would the bank do if a customer has any confusion while doing transaction on religious grounds? Do you have an Islamic council desk where he/she can consult with someone or refer the literature?

Yes, BOK has its Shariah Department which the customers can consult if they have any confusion regarding any Islamic transaction