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## APPENDIX 2. ISLAMIC BANKING<sup>54</sup>

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**483.** Activities of Islamic financial institutions differ from those of standard commercial depository corporations in that predetermined interest on financial transactions is prohibited<sup>55</sup>. However, commercial trade and investment for profit are acceptable and encouraged. Islamic financial institutions operate by participating in investments, sharing profits on projects, and earning fees for services rendered. For example, Islamic financial institutions offer investors/depositors participation in risk-bearing, open-ended, mutual fund-type packages rather than fixed interest on deposits.

**484.** Several special types of depository accounts and financial instruments permit Islamic financial institutions to engage in some commercial banking activities. Generally, any risk-bearing instrument reflecting a real asset and earning a variable rate of return tied to the performance of the asset is considered to be consistent with Islamic law. Use of financial instruments with returns specified before investment is not permitted, but sharing of the returns by some formula after the fact is acceptable. Some financial activities may have some sort of established rate of return that could be created, for example, by the purchase and resale of trade goods at trade margins affected by market competition or standard practices.

**485.** The functions of Islamic financial institutions can be divided into two parts: the safeguarding of deposits and the partnership of financial institutions with shareholders and depositors in profit-making ventures. Demand deposit facilities (called *Amanah* or *Qard-hasan deposits*) are similar to the safekeeping and transferable deposit functions performed in

standard commercial banking. The *Amanah* or *Qard-hasan* deposits pay no returns, and the financial institution is obligated to preserve the nominal value of the deposit. (For purposes of preparing monetary statistics, Islamic deposit facilities should be treated in the same way as standard deposits in depository corporations.)

**486.** The partnership activities of Islamic financial institutions have mixed features that include conventional bank intermediation, mutual funds, or limited partnerships. To a large extent, Islamic financial institutions act as conventional intermediaries by issuing deposit-like instruments to the public in order to raise funds to finance commercial activity. The deposit-like instruments and the financial institutions' investments must be designed to expose both the depositors and the financial institutions to profits or losses on the ventures. Thus, the investments—many are negotiable and known by names such as “participation term certificates,” “profit and loss sharing (PLS) certificates,” and “investment deposit certificates”—have properties similar to those of shares in a company or a mutual fund.

**487.** An Islamic financial institution serving as an intermediary may act as a partner or as a provider of services in profit-making ventures and thus has some characteristics in common with mutual funds, financial leasing companies, or brokers. Because of the joint participation among an Islamic financial institution, shareholders, and depositors in equity investments, the financial institution per se is not as exposed to risk as is a conventional, commercial, financial intermediary. In addition, the structure of the balance sheet of an Islamic financial institution may differ from that of a standard commercial depository corporation. For example, the equity capital base of an Islamic financial institution may be larger than that of a commercial depository corporation; an Islamic financial institution's loan portfolio may be concentrated in short-term trade instruments; and the nature of banking strategies and risks may differ.

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<sup>54</sup>This appendix draws on Zubair Iqbal and Abbas Mirakhor, *Islamic Banking* (Washington: International Monetary Fund, 1987).

<sup>55</sup>The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has set accounting, auditing, governance, Shari'a and ethical standards for Islamic financial institutions. The AAOIFI is a self-regulatory international autonomous non-profit organization that was established in 1991 in Bahrain.

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**488.** The prevailing statistical practice is to classify Islamic financial institutions in the *other depository corporations* subsector. The implication of this practice is that participation certificates and other investment deposits are treated the same way as regular deposits for statistical reporting purposes. The participation of many Islamic financial institutions in bank clearing systems and a concentration of lending activity in traditional, short-term commercial and trade financing are practices that tend to reinforce this classification. Islamic financial institutions that are not primarily involved in deposit-taking activities are classified as other financial corporations. Islamic financial institutions investing mainly as long-term partners in business ventures are akin to mutual funds, and the liabilities of these financial institutions to the public should be classified as stock.

**489.** The following list details sources of funds for Islamic financial institutions.

- *Amanah and Qard-hasan deposits* are conventional deposit and transfer accounts for safekeeping and transferable checking, and they pay no returns. The deposits are usually considered part of the resources of the financial institution, but the financial institution is required to guarantee the face value of the deposits.
- A *Mudarabah* is a contract between investors and a financial institution that, as a silent partner, invests deposits in a commercial activity that earns each partner an agreed-upon portion of the profits on the venture. A *Mudarabah* can be entered into for a single investment or on a continuing basis with the financial institution acting as a fiduciary. *Mudarabah* investments may be made for fixed terms and arranged through negotiable instruments (called investment deposit certificates or *Mudarabah* certificates) and thus may have characteristics similar to those of stock.
- *Participation term certificates* are long-term investment instruments that entitle the holder to a share of a corporation's profit.

These certificates should be classified as deposits if the certificates are treated as liabilities of a financial institution and are not part of its permanent capital base.

- *Profit and loss sharing certificates* and *investment deposit certificates* are investors' deposits, such as *Mudabah* certificates, that resemble shares in a company and should be classified as deposits.

**490.** The following list covers the primary types of credit supplied by Islamic financial institutions.

- *Qard-hasan loans* are return-free loans that are made to needy individuals or for some social purpose.
- *Murabaha* refers to contracts in which a financial institution purchases goods upon the request of a client, who makes deferred payments that cover costs and an agreed-upon profit margin for the financial institution. The financial institution handles payments to a supplier and incidental expenses of delivery (against a deferred payment that is made by the buyer to cover delivery costs and an agreed-upon share of the buyer's markup). *Murabaha* should be classified as loans.
- A *Musharakah* is a partnership between a financial institution and an enterprise in which the financial institution supplies working capital. Notes of participation sold to investors provide the funding. A *Musharakah* should be classified as a loan.
- An *Ijara* is a lease-purchase contract in which a financial institution purchases capital equipment or property and leases it to an enterprise. The financial institution may either rent the equipment or receive a share of the profits earned through its use. An *Ijara* should be classified as a loan.
- *Ijara Wa Iktina* are the same as *Ijara* except that the lessee can acquire ownership of the asset by making installment payments. *Ijara Wa Iktina* should be classified as loans.

- A *Salaf* (sometimes referred to as *Salam*) is a short-term agreement in which a financial institution makes full prepayments for future delivery of a specified quantity of goods on a specified date. A *Salaf* should be classified as a loan.

- Zakat funds are special funds that are maintained by Islamic financial institutions, used for social purposes, and financed by contributions from depositors. Zakat funds are not part of the financial institution's sources of funds.

**491.** The 1993 SNA classification scheme for financial instruments can provide additional detail to include special categories for Islamic financial instruments that compilers may use to separately identify Islamic instruments. For example:

- *Islamic instruments—deposits* include conventional and transferable deposits as well as various investment participation certificates that are not investments in the permanent capital of a financial institution and do not have the characteristics of tradable securities.

- *Islamic instruments—securities other than shares* consist of various investment participation certificates that have the characteristics of tradable securities and are not investments in the permanent capital of a financial institution. Included in this category are the most tradable investment certificates recorded as liabilities of a financial corporation.

- *Islamic instruments—loans* cover arrangements in which a financial institution makes prepayments, finances ventures or trade, or supplies working capital to clients. The arrangements may include short-term or other partnerships in which a financial institution is not making permanent, equity-type investments.

- *Islamic instruments—shares and other equity* include various investment participation certificates that are part of the permanent capital of a financial institution or are clearly representative of a partnership between an investor and a financial corporation.