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KİLİS 7 ARALIK ÜNİVERSİTESİ

SOSYAL BİLİMLER ENSTİTÜSÜ

İŞLETME ANABİLİM DALI

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AN APPLICATION OF THE RELATIONSHIP BETWEEN U.A.E. ISLAMIC BANKS AND U.A.E. CENTRAL BANK

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Bu tez tarafımızca okunmuş, kapsamı ve niteliği açısından bir Yüksek Lisans Tezi olarak kabul edilmiştir.

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Bu belge ile, bu ödevdeki bütün bilgilerin akademik kurallara ve etik davranış ilkelerine uygun olarak toplanıp sunulduğunu ve bu kural ve ilkelerin gereği olarak, çalışmada bana ait olmayan tüm veri, düşünce ve sonuçları anladığımı ve kaynağını gösterdiğimi beyan ederim.(……/……/2015)

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İmzası

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ÖZET

BIRLEŞİK ARAP EMIRLIKLERINDE İSLAM BANKACILIĞI VE MERKEZ BANKASI ARASINDAKİ İLİŞKİ ÜZERİNE BİR UYGULAMA

ABORASS, Nour
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Tez Danışmanı: Prof. Dr. H. Mustafa PAKSOY
Ocak 2015,116 Sayfa

Bu tezin amacı birleşik Arap emirliklerin merkez banka ve islam bankaları arasında akışı göstermek,bu akışı açıklamak için araştırıcı merkez banaka ,özellikleri ve amaçları konuşmaya başladı ,ve islam banka ve olduğunu ve amaçlarını.

Andan sonar araştırıcı merkez banka ve islam bankaları arasında akışı konuşacak ve nasıl merkez bankanın siyasettleri islam bankaların işlerine etkinliyor.

Ondan sonra araştırıcı birleşik Arap emirliklerin'de merkez Banka ve İslam bankalar arasında ilişkileri araştırır ve birleşik Arap emirlikleri merkez bankanın siyasetleri Emiraet İslam bankaya nasıl etkinleştirir.

Anahter kelimeler:Merkez banka , İslam banka, İslami bankacılık, ilişki, Birleşik Arap Emirlikleri.

ABSTRACT

AN APPLICATION OF THE RELATIONSHIP BETWEEN U.A.E ISLAMIC BANKS AND U.A.E. CENTRAL BANK.

ABORASS, Nour
Master's Thesis: Department of Business
Supervisor: Prof. Dr. H. Mustafa PAKSOY
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This research aims to view the relationship between Islamic bank and central bank in United Arab Emirates. To explain this relation the researcher started to explain what is the central bank, objectives of central bank, and characteristics, what is Islamic bank and objectives of Islamic bank. Then the researcher will speak about the relationship between Islamic bank and central bank from the side of how central bank's politics will impact in Islamic bank working. After that the researcher will take United Arab Emirates as an example to view this relation between Islamic banks (Emirates Islamic bank and central bank of U.A.E.).How central bank's politics will impact in Emirates Islamic bank.

Keywords: central bank, Islamic bank, Islamic banking, relationship, United Arab Emirates.

CONTETS

SECOND CHAPTER
ISLAMIC BANKING

THIRD CHAPTER
ISLAMIC FINANCEINSTRUMENTS

FOURTH CHAPTER
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FIFTH CHAPTER
THE RELATION OF UNITED ARAB EMIRATES WITH EMIRATES ISLAMIC BANK

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DIAGRAM LIST:

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Abbreviation	**Definition**
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BIS	Bank for International Settlements
CBJ	Central Bank of Jordan
ECB	European Central Bank
FSAP	Financial Services Action Plan
IFTS	Interbank Funds Transfer System
IMF	International Monetary Fund
OIC	Organization of Islamic conference
PLS	Profit and Loss System
QIB	Qatar Islamic bank
UAE	United Arab Emirates
USA	United States America
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions.

FIRST CHAPTER

CENTRAL BANK

1. INTRODUCTION

Central banking performs an important role in regulating commercial banks, Islamic banks and their various activities. The functions of a central bank are well known. A central bank is the government's bank as it keeps the deposits of the government and advances loans to it.

It controls the supply of high powered money by having taking others measures. It is also a banker's bank as commercial banks keep their deposits with the central bank and it may advance loans to them at the time of a need by functioning as the lender of the last resort while all of these. Functions constitute important dimensions of central banking operations, probably the most important task of a central bank is to control the credit created by commercial banks. This level through which the monetary the techniques to which central banks resort to control commercial banks credit creations are also well known and include: legal reserve ratio, bank ratio or discount ratio policy, open markets operations, qualitative or selective credit control and moral suasion. With the emergence of Islamic banks in several countries belonging to the organization of Islamic conference (OIC) and with some countries commuting themselves to the full scale islamization of their banking sector.

The central bank uses selective methods of qualitative and quantitative credit control, either in order to influence the final use of credit it the channel it in certain desirable directions.

Furthermore, from point of view of relation between Islamic banks and central banks, three cases can be distinguished

1) Firstly, there are some countries where Islamic banks are commutated within the frame work of the existing banking laws. This is the case with Islamic banks operating in Western Europe.
2) Secondary, there are countries where special laws have been enacted allowing Islamic banks to function. This is case in Jordan, Egypt, Turkey, Malaysia and several other Islamic countries However, this legislation is mostly confined to the working of only a few Islamic financial institutions.
3) Thirdly, there are some countries where a comprehensive legal frame work has been created for the Islamic banking system. This is the case in Pakistan and Iran and to some extent in Sudan.

1.1-Objective of the study:

The objective of this study maybe started as follows:

1-To study the practices of central banks in regulating and controlling Islamic banks.

2-Defining the control of central bank concept on the Islamic banks.

3-To study the relationship of Islamic banks with central bank in the U.A.E.

1.2-Problems of the study:

1-What the impact of the central bank supervision in Islamic bank working? And if will be this controls with positive impacts in Islamic banks?

2-Do it take into account central bank supervision the nature of Islamic bank mechanisms, works and their investments.

1.3-The limits of this study:

This study (the relationship between emirates Islamic bank and U.A.E central bank) was limited by a variables that available on the internet.

1.4-The importance of the study:

To illustrate the relation between Islamic banks and central bank.

1.5-Hypothesis of the study:

Some of the controls used by central bank to impact on Islamic banks working are not suitable.

1.6-Research methodology:

Using statistical program SPSS.

Collecting the information from the books, previous studies and websites.

1.7-Previous study:

(Kurait, 2011) The title was: study the impact of the central bank supervision in deposits and credit in the Islamic banking application on Syria international Islamic bank

The aim of this study, studying the impact of supervision central bank in deposits and credit in Islamic bank to protect the right of depositors.

The recommendations that he gives it should be special transaction between Islamic bank and central bank.

- (Nasir, 2005) The title of this study was about the relation of Islamic bank with central bank. The aims of this study was about:
    1. What the real relation between Islamic bank and central bank
    2. Try to visualize the framework if the relationship between Islamic banks and central bank, what the objective is responded from central bank to Islamic bank

- (Altarad, 1424) The title of this study the relationship of Islamic banks in Jordan with central bank of Jordan. The aim of this study is to illustrate the relationship between the central bank of Jordan (CBJ) and Islamic banks operating Jordan whereas the researcher renewed the CBJ control instruments, legislations and its regulations on the working of the Islamic banks in Jordan.

The researchers concluded the study by offering some recommendations, which could contribute in under taking an adjustment procedure for some control instrument, and to allow new elements for the benefits of the Islamic banks. Therefore, this will lead to an investment of excess liquidity that available with Islamic banks.

- (Aluadi, no date) the title of this study was about "regulatory and economic impacts of the central bank on deposits and credit in Islamic banks".

The aims of this study to talk about the central bank is manager of monetary policy. Thus it plays the role of controller in the banking system.

And this study was talked about how central banks use the same instruments which it used in the control on the traditional banks, and how the process had their effects on the control and economic aims.

And the researcher put his recommendation about central if he understand the Islamic bank operation that will be able to use the suitable instruments for the control on Islamic banks.

- (Saqir, Almuhtesib, 2013) the title was “conditioning the supervisory role of central banks to deal with Islamic banks”. The aims if the study is to identify the appropriateness of the traditional means of central banks to control the application of the Islamic banks. And the study aims to explore the problems and obstacles that can result from this application and adapted a number of relevant Shariah standards.

1.8-History of Central Bank.

Central bank is the term used to describe the authority responsible for policies that affect country’s supply for money and credit.

More specifically, a central bank uses it tools of monetary policy – open market, discount window leading change in reserve requirements – to affect short term interest rates and the monetary base (currency held by the public plus bank reserves) in order to achieve important policy goals.

There are three key goals of modern monetary policy.

The first and most important is price stability.

The second goal is a stable real economy, of inter prated as high employment and high and sustainable economy growth.

The third goal is financial stability.

The story of central banking goes back at least to the seventeenth century. To the founding of the first institution recognized as a central bank the Swedish risks bank established in 1668 as a joint stock bank, it was chartered to lend the government funds and to act as clearing house for commerce.

A few decades later (1694), the most famous central bank of the area the bank of England, was founded also as a joint stock company to purchase government debt. Other central banks were setup later in Europe for similar purposes.

Early central banks issued private notes which served as currency and they often had a monopoly over such note issues while these early central banks, helped fund the government’s debt, they were also private entities that engaged in banking activities. Because they held the deposits of other banks. They came to serve banks for bankers, facilitating transactions between banks of providing other banking services.

They became the repository for most banks in the banking system because of their large reserves and extensive networks of correspondent banks.

The factors allowed them to become the lender of last resort in face of a financial crisis. In other words, they became willing to provide emergency cash to their correspondents in times of financial distress.

1.9. Central Bank:

A government established agency responsible for controlling the nation's money supply and credit conditions and supervising the financial system especially in commercial banks and other depository institutions.

The objectives of the central bank:

1-to save the monetry stability in the country

2-to encourage the ability of changing the country's currency

3-to motivate the economic growth according to the public economic policy of the government.

1.10. Activities and responsibilities

Functions of a central bank may include:

1-implementing monetary policies.

2-determining Interest rates

3-controlling the nation's entire money supply

4-the Government's banker and the bankers' bank ("lender of last resort")

5-managing the country's foreign exchange and gold reserves and the Government's stock register

6-regulating and supervising the banking industry

7-setting the official interest rate – used to manage both inflation and the country's exchange rate and ensuring that this rate takes effect via a variety of policy mechanisms. (http://en.wikipedia.org, 2014)

1.11-The main characteristics (functions) of a central bank are given as below:

1.11.1-Note issue: The main features of a central bank is the issue of currency in the country in accordance with requirements of business and the general public.

(www.assignmentpoint.com, 19-10-2014).

The central bank has the sole monopoly of note issue in almost every country. The currency notes pointed and issued by the central bank become unlimited legal tender throughout the country.

In the words of – kock -, “the privilege of note-issue was almost everywhere associated with the origin and development of central banks”.

However, the monopoly of central bank to issue the currency notes may be partial in certain countries.

The main advantages of giving the monopoly right of note issue to the central bank are given below:

1) It brings uniformity in the monetary system of note issue and note circulation.
2) The central bank can exercise better control over the money supply in the country. It increase public confidence in the monetary system of the country.
3) Monetary management of the paper currency becomes easier. Being the supreme bank of the country. The central bank has full information about the monetary requirements of the economy and, therefore, can change the quantity of currency accordingly.
4) It enables the central bank to exercise control over the certain of credit by commercial banks.
5) The central bank also earns profit from the issue of paper currency. (www.preservearticles.com, 26-10-2014).
6) Grating of monopoly right of note issue to the central bank avoids the political interference in the matter of note issue.

1.11.2-Banker to the government. The central bank is the banker to the government and also acts as it fiscal agent.

The government keeps it balances with free of interest. It receives and disburses the payments on behalf of the government and also maker’s advances to the government. (www.assignmentpoint.com, 19-10-2014).

As a banker to government. The central bank performs the same functions for the government as a commercial bank performs for its customers. It maintains the accounts of the central as well as state government; it receives deposits from government; it makes short term advances to the government; it collects cheques and drafts deposits in the government account, it provides foreign exchange resources to the government for repaying external debt or purchasing foreign goods or making other payments.

As a financial adviser to the lent, the central bank gives to the government on economic, monetary financial and fiscal matters such as deficit financing, devaluation, trade policy, foreign exchange policy, etc.
(www.preservearticles.com, 26-10-2014).

1.11.3-Banker's bank: the central bank also act as the banker to the scheduled and other banks.

It is the custodian of the cash reserves of the commercial banks. Every scheduled bank is required to maintain not less than 50% of its total demand and time liabilities with the central bank. Against these obligations. The scheduled banks are entitled to loan and rediscount facilities from the bank.

This reserve with the central is considered as good as liquid cash.

The provision of reserve enables the central bank to have control over the credit creation of the commercial banks.(www.assignmentpoint.com, 19-10-2014).

The central bank acts as the banker's bank in three capacities:

1) Custodian of the cash preserves of commercial banks.
2) As the lender of the last resort.
3) And as clearing agent. In this way the central bank acts as a friend, philosopher and guide to the commercial banks.

As a custodian of the cash reserves of the commercial banks. Every commercial bank has to keep a certain percentage of its cash balances as deposits with the central banks. These cash reserves can be utilized by the commercial banks in times of emergency.

1.11.3.1-The centralization of cash reserves in the central bank has the following advantages:

1) Centralized cash reserves inspire confidence of the public in the banking system of the country.
2) Centralized cash reserves provide the basis of a larger and more elastic credit structure than if these amounts were scattered among the individual banks.

3) The centralized cash reserves can be used to the fullest possible extent and in the most effective manner during the periods of seasonal strains and financial emergencies.
4) Centralized cash reserves enable the central bank to provide financial accommodation to the commercial banks which are in temporary difficulties. In fact the central bank functions as the lender of the last resort on the basis of the centralized cash reserves.
5) The system of the centralized cash reserves enables the central bank to influence the certain of credit by the commercial banks by increasing or decreasing the cash reserves through the technique of variable cash reserve ratio.
6) The cash reserves with the central bank can be used to promote national welfare. (www.preservearticles.com, 26-10-2014).

1.11.4- Lender of last Resort: The central bank is the lender of last resort. It provide a close relationship with the commercial banks.

Central banks takes the responsibility of meeting directly or indirectly all reasonable demands for accommodation from the commercial banks and other credit institutions under certain terms and conditions.

In the other words, in case the commercial banks are not able to meet their financial requirements from other sources, they can as a last resort, approach the central bank for financial accommodation.

The central bank provides financial accommodation to the commercial banks by rediscounting their eligible securities and exchange bills.

1.11.4.1-The advantages of the central bank's functioning as the lender of the last resort are:

1) It increases the elasticity and liquidity of the whole credit structure of the economy.
2) It enables the commercial banks to carry on their activities even with their limited cash reserves.
3) It provides financial help to the commercial banks in times of emergency.
4) It enables the central bank to exercise its control over banking system of the country. (www.preservearticles.com, 27-10-2014).

1.11.5- Clearing house: the central bank acts as the clearing house for other banks. Under this function the central bank facilitates the settlement of bills and cheques of other banks by setting off demands of one against other and thus helps the funct**:** One of the important functions of central bank is to regulate and control the credit in the country according to the varying economics situations.

Bank rate policy and open market operations are the direct methods of central bank for controlling credit. It can decrease or increase reserves ratio and control the advances policy of commercial banks. (www.assignmentpoint.com, 20-10-2014).

Ironing of the banking system so smoothly without actual cash transactions.

1.11.5.1-The clearing house function of the central bank has the following advantages:

1) It economies the use of cash by banks while setting their claims and counter-claims.
2) It reduces the withdrawals of cash and these enable the commercial banks to create credit on a large scale.
3) It keeps the central banks fully informed about the liquidity position of the commercial banks. (www.preservearticles.com, 20-10-2014).

1.11.6- Controller of foreign exchange: the central bank is responsible for the management of foreign exchange and maintaining external value of price.

1.12-Monetary policy

Central banks implement a country's chosen monetary policy. At the most basic level, this involves establishing what form of currency the country may have, whether a fiat currency, gold-backed currency (disallowed for countries with membership of the International Monetary Fund), currency board or a currency union. When a country has its own national currency, this involves the issue of some form of standardized currency, which is essentially a form of promissory note: a promise to exchange the note for "money" under certain circumstances. Historically, this was often a promise to exchange the money for precious metals in some fixed amount. Now, when many currencies are fiat money, the "promise to pay" consists of the promise to accept that currency to pay for taxes.

A central bank may use another country's currency either directly (in a currency union), or indirectly (a currency board). In the latter case, exemplified by Bulgaria, Hong Kong and Latvia, the local currency is backed at a fixed rate by the central bank's holdings of a foreign currency.

The expression "monetary policy" may also refer more narrowly to the interest-rate targets and other active measures undertaken by the monetary authority.

1.12.1-Goals of monetary policy:

1.12.1.1-High employment:

Frictional unemployment is the time period between jobs when a worker is searching for, or transitioning from one job to another. Unemployment beyond frictional unemployment is classified as unintended unemployment.

For example, structural unemployment is a form of unemployment resulting from a mismatch between demand in the labour market and the skills and locations of the workers seeking employment. Macroeconomic policy generally aims to reduce unintended unemployment.

Keynes labeled any jobs that would be created by a rise in wage-goods (i.e., a decrease in real-wages) as involuntary unemployment:

Men are involuntarily unemployed if, in the event of a small rise in the price of wage-goods relatively to the money-wage, both the aggregate supply of labor willing to work for the current money-wage and the aggregate demand for it at that wage would be greater than the existing volume of employment.

1.12.1.2-Price stability:

Inflation is defined either as the devaluation of a currency or equivalently the rise of prices relative to a currency.

Since inflation lowers real wages, Keynesians view inflation as the solution to involuntary unemployment. However, "unanticipated" inflation leads to lender losses as the real interest rate will be lower than expected. Thus, Keynesian monetary policy aims for a steady rate of inflation.

1.12.1.3-Economic growth:

Economic growth can be enhanced by investment in capital, such as more or better machinery. A low interest rate implies that firms can loan money to invest in their capital stock and pay less interest for it. Lowering the interest is therefore considered to encourage economic growth and is often used to alleviate times of low economic growth. On the other hand, raising the interest rate is often used in times of high economic growth as a contra-cyclical device to keep the economy from overheating and avoid market bubbles.

Interest rate stability

Financial market stability

Foreign exchange market stability

Conflicts among goals:

Goals frequently cannot be separated from each other and often conflict. Costs must therefore be carefully weighed before policy implementation.

1.12.1.4-Currency issuance

Similar to commercial banks, central banks hold assets (government bonds, foreign exchange, gold, and other financial assets) and incur liabilities (currency outstanding). Central banks create money by issuing interest-free currency notes and selling them to the public in exchange for interest-bearing assets such as government bonds. When a central bank wishes to purchase more bonds than their respective national governments make available, they may purchase private bonds or assets denominated in foreign currencies.

The European Central Bank remits its interest income to the central banks of the member countries of the European Union. The US Federal Reserve remits all its profits to the U.S. Treasury. This income, derived from the power to issue currency, is referred to as seigniorage, and usually belongs to the national government. The state-sanctioned power to create currency is called the Right of Issuance. Throughout history there have been disagreements over this power, since whoever controls the creation of currency controls the seigniorage income.

1.12.1.5-Interest rate interventions:

Typically a central bank controls certain types of short-term interest rates. These influence the stock- and bond markets as well as mortgage and other interest rates. The European Central Bank for example announces its interest rate at the meeting of its Governing Council; in the case of the U.S. Federal Reserve, the Federal Reserve Board of Governors.

Both the Federal Reserve and the ECB are composed of one or more central bodies that are responsible for the main decisions about interest rates and the size and type of open market operations, and several branches to execute its policies. In the case of the Federal Reserve, they are the local Federal Reserve Banks; for the ECB they are the national central banks.

1.12.1.6-Limits on policy effects

Although the perception by the public may be that the "central bank" controls some or all interest rates and currency rates, economic theory (and substantial empirical evidence) shows that it is impossible to do both at once in an open economy. Robert Mundell's "impossible trinity" is the most famous formulation of these limited powers, and postulates that it is impossible to target monetary policy (broadly, interest rates), the exchange rate (through a fixed rate) and maintain free capital movement. Since most Western economies are now considered "open" with free capital movement, this essentially means that central banks may target interest rates or exchange rates with credibility, but not both at once.

In the most famous case of policy failure, Black Wednesday, George Soros arbitraged the pound sterling's relationship to the ECU and (after making $2 billion himself and forcing the UK to spend over $8bn defending the pound) forced it to abandon its policy. Since then he has been a harsh critic of clumsy bank policies and argued that no one should be able to do what he did.

The most complex relationships are those between the yuan and the US dollar, and between the euro and its neighbors. The situation in Cuba is so exceptional as to require the Cuban peso to be dealt with simply as an exception, since the United States forbids direct trade with Cuba. US dollars were ubiquitous in

Cuba's economy after its legalization in 1991, but were officially removed from circulation in 2004 and replaced by the convertible peso.

1.13-Policy instruments:

The main monetary policy instruments available to central banks are open market operation, bank reserve requirement, interest rate policy, re-lending and re-discount (including using the term repurchase market), and credit policy (often coordinated with trade policy). While capital adequacy is important, it is defined and regulated by the Bank for International Settlements, and central banks in practice generally do not apply stricter rules.

To enable open market operations, a central bank must hold foreign exchange reserves (usually in the form of government bonds) and official gold reserves. It will often have some influence over any official or mandated exchange rates: Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float").

1.13.1-Interest rates:

By far the most visible and obvious power of many modern central banks is to influence market interest rates; contrary to popular belief, they rarely "set" rates to a fixed number. Although the mechanism differs from country to country, most use a similar mechanism based on a central bank's ability to create as much fiat money as required.

The mechanism to move the market towards a 'target rate' (whichever specific rate is used) is generally to lend money or borrow money in theoretically unlimited quantities, until the targeted market rate is sufficiently close to the target. Central banks may do so by lending money to and borrowing money from (taking deposits from) a limited number of qualified banks, or by purchasing and selling bonds. As an example of how this functions, the Bank of Canada sets a target overnight rate, and a band of plus or minus 0.25%. Qualified banks borrow from each other within this band, but never above or below, because the central bank will always lend to them at the top of the band, and take deposits at the bottom of the band; in principle, the capacity to borrow and lend at the extremes of the band are unlimited.

Other central banks use similar mechanisms.

It is also notable that the target rates are generally short-term rates. The actual rate that borrowers and lenders receive on the market will depend on (perceived) credit risk, maturity and other factors. For example, a central bank might set a target rate for overnight lending of 4.5%, but rates for (equivalent risk) five-year bonds might be 5%, 4.75%, or, in cases of inverted yield curves, even below the short-term rate. Many central banks have one primary "headline" rate that is quoted as the "central bank rate". In practice, they will have other tools and rates that are used, but only one that is rigorously targeted and enforced.

"The rate at which the central bank lends money can indeed be chosen at will by the central bank; this is the rate that makes the financial headlines." – Henry C.K. Liu. [Liu explains further that "the U.S. central-bank lending rate is known as the Fed funds rate. The Fed sets a target for the Fed funds rate, which its Open Market Committee tries to match by lending or borrowing in the money market ... a fiat money system set by command of the central bank. The Fed is the head of the central-bank because the U.S. dollar is the key reserve currency for international trade. The global money market is a USA dollar market. All other currencies markets revolve around the U.S. dollar market." Accordingly the U.S. situation is not typical of central banks in general.

A typical central bank has several interest rates or monetary policy tools it can set to influence markets.

Marginal lending rate (currently 0.30% in the Eurozone) – a fixed rate for institutions to borrow money from the central bank. (In the USA this is called the discount rate).

Main refinancing rate (0.05% in the Eurozone) – the publicly visible interest rate the central bank announces. It is also known as minimum bid rate and serves as a bidding floor for refinancing loans. (In the USA this is called the federal funds rate).

Deposit rate, generally consisting of interest on reserves and sometimes also interest on excess reserves (-0.20% in the Eurozone) – the rates parties receive for deposits at the central bank.

These rates directly affect the rates in the money market, the market for short term loans.

1.13.2-Open market operations:

Through open market operations, a central bank influences the money supply in an economy. Each time it buys securities (such as a government bond or Treasury bill), it in effect creates money. The central bank exchanges money for the security, increasing the money supply while lowering the supply of the specific security. Conversely, selling of securities by the central bank reduces the money supply.

Open market operations usually take the form of:

Buying or selling securities ("direct operations") to achieve an interest rate target in the interbank market.

Temporary lending of money for collateral securities ("Reverse Operations" or "repurchase operations", otherwise known as the "repo" market). These operations are carried out on a regular basis, where fixed maturity loans (of one week and one month for the ECB) are auctioned off.

Foreign exchange operations such as foreign exchange swaps.

All of these interventions can also influence the foreign exchange market and thus the exchange rate. For example the People's Bank of China and the Bank of Japan have on occasion bought several hundred billions of U.S. Treasuries, presumably in order to stop the decline of the U.S. dollar versus the renminbi and the yen.

1.13.3-Capital requirements

All banks are required to hold a certain percentage of their assets as capital, a rate which may be established by the central bank or the banking supervisor. For international banks, including the 55 member central banks of the Bank for International Settlements, the threshold is 8% (see the Basel Capital Accords) of risk-adjusted assets, whereby certain assets (such as government bonds) are considered to have lower risk and are either partially or fully excluded from total assets for the purposes of calculating capital adequacy. Partly due to concerns about asset inflation and repurchase agreements, capital requirements may be considered more effective than reserve requirements in preventing indefinite lending: when at the threshold, a bank cannot extend another loan without acquiring further capital on its balance sheet.

1.13.4-Reserve requirements:

Historically, bank reserves have formed only a small fraction of deposits, a system called fractional reserve banking. Banks would hold only a small percentage of their assets in the form of cash reserves as insurance against bank runs. Over time this process has been regulated and insured by central banks. Such legal reserve requirements were introduced in the 19th century as an attempt to reduce the risk of banks overextending themselves and suffering from bank runs, as this could lead to knock-on effects on other overextended banks. See also money multiplier.

As the early 20th century gold standard was undermined by inflation and the late 20th century fiat dollar hegemony evolved, and as banks proliferated and engaged in more complex transactions and were able to profit from dealings globally on a moment's notice, these practices became mandatory, if only to ensure that there was some limit on the ballooning of money supply. Such limits have become harder to enforce. The People's Bank of China retains (and uses) more powers over reserves because the yuan that it manages is a non-convertible currency.

Loan activity by banks plays a fundamental role in determining the money supply. The central-bank money after aggregate settlement – "final money" – can take only one of two forms:

-Physical cash, which is rarely used in wholesale financial markets, Central bank money which is rarely used by the people.

-The currency component of the money supply is far smaller than the deposit component. Currency, bank reserves and institutional loan agreements together make up the monetary base, called M1, M2 and M3. The Federal Reserve Bank stopped publishing M3 and counting it as part of the money supply in 2006.

1.13.5-Exchange requirements:

To influence the money supply, some central banks may require that some or all foreign exchange receipts (generally from exports) be exchanged for the local currency. The rate that is used to purchase local currency may be market-based or arbitrarily set by the bank. This tool is generally used in countries with non-convertible currencies or partially convertible currencies. The recipient of the local currency may be allowed to freely dispose of the funds, required to hold the funds with the central bank for some period of time, or allowed to use the funds subject to certain restrictions. In other cases, the ability to hold or use the foreign exchange may be otherwise limited.

In this method, money supply is increased by the central bank when it purchases the foreign currency by issuing (selling) the local currency. The central bank may subsequently reduce the money supply by various means, including selling bonds or foreign exchange interventions.

1.13.6-Margin requirements and other tools

In some countries, central banks may have other tools that work indirectly to limit lending practices and otherwise restrict or regulate capital markets. For example, a central bank may regulate margin lending, whereby individuals or companies may borrow against pledged securities. The margin requirement establishes a minimum ratio of the value of the securities to the amount borrowed.

Central banks often have requirements for the quality of assets that may be held by financial institutions; these requirements may act as a limit on the amount of risk and leverage created by the financial system. These requirements may be direct, such as requiring certain assets to bear certain minimum credit ratings, or indirect, by the central bank lending to counterparties only when security of a certain quality is pledged as collateral. (www.en.wikipedia.org, 21-11-2014).

1.14-Central bank independence

Central bank independence refers to the freedom monetary policy makers from direct political or governmental in fluencies in the conduct of policy.

During the 1970s and earlier 1980s, major industrialized economies experienced sustained periods of high inflation. To explain these periods of inflation, one must account for why central banks allowed them to happen. One influential line of argument pointed to the inflation bias inherent in discretionary monetary policy if the central bank’s objective for real output (unemployment) is above (below) the economy’s natural equilibrium level or if policy makers simply prefer higher output level (Barro and Gordon 1983).

Under rational expectation, the public anticipates the central bank will attempt to expand the economy as a consequence, a real output is not systematically affected but average inflation is left in efficiently high.

1.14.1-The meaning of independence.

The historical, legal, and de facto relationship between a country's government and its central bank is very complex, involving many difference aspects. These include, but are not limited to the role of the government in appointing (and dismissing) members of the central bank governing board. The voting power (ifany) of the government on the boards, the degree to which the central bank is subject to budgetary control by the government, the extent to which the central bank must lend to government, and whether there are clearly defined policy goals established in the central bank's charter.

1.14.2-Independence and accountability

While many countries have grated their central banks more independence, the idea that central banks should be completely independent has come under criticism. This criticism focuses on the danger that a central bank that is independent will not be accountable.

Although maintaining law and stable inflation is as important societal goal, it is not the only macro-economic goal. Monetary policy may have no long run effect on real economic variables, but it can affect the real economy in the short run.

In democracy, delegating policy to an independent agency requires some mechanism to ensure accountability. For this reason, reforms have often granted central banks instrument independence while preserving a role for the elected government in establishing the goals of policy and in maintaining the central bank's performance in achieving these goals. (Carle Walsh, 2005, p.1, p.3, p.8).

In the 2000s there has been a trend towards increasing the independence of central banks as a way of improving long-term economic performance. However, while a large volume of economic research has been done to define the relationship between central bank independence and economic performance, the results are ambiguous.

Advocates of central bank independence argue that a central bank which is too susceptible to political direction or pressure may encourage economic cycles ("boom and bust"), as politicians may be tempted to boost economic activity in advance of an election, to the detriment of the long-term health of the economy and the country. In this context, independence is usually defined as the central bank's operational and management independence from the government.

The literature on central bank independence has defined a number of types of independence.

1.14.2.1-Legal independence

The independence of the central bank is enshrined in law. This type of independence is limited in a democratic state; in almost all cases the central bank is accountable at some level to government officials, either through a government minister or directly to a legislature. Even defining degrees of legal independence has proven to be a challenge since legislation typically provides only a framework within which the government and the central bank work out their relationship.

1.14.2.2-Goal independence

The central bank has the right to set its own policy goals, whether inflation targeting, control of the money supply, or maintaining a fixed exchange rate. While this type of independence is more common, many central banks prefer to announce their policy goals in partnership with the appropriate government departments. This increases the transparency of the policy setting process and thereby increases the credibility of the goals chosen by providing assurance that they will not be changed without notice. In addition, the setting of common goals by the central bank and the government helps to avoid situations where monetary and fiscal policy are in conflict; a policy combination that is clearly sub-optimal.

1.14.3-Operational independence:

The central bank has the independence to determine the best way of achieving its policy goals, including the types of instruments used and the timing of their use. This is the most common form of central bank independence. The granting of independence to the Bank of England in 1997 was, in fact, the granting of operational independence; the inflation target continued to be announced in the Chancellor's annual budget speech to Parliament.

1.14.4-Management independence

The central bank has the authority to run its own operations (appointing staff, setting budgets, and so on.) without excessive involvement of the government. The other forms of independence are not possible unless the central bank has a significant degree of management independence. One of the most common statistical indicators used in the literature as a proxy for central bank independence is the "turn-over-rate" of central bank governors. If a government is in the habit of appointing and replacing the governor frequently, it clearly has the capacity to micro-manage the central bank through its choice of governors.

It is argued that an independent central bank can run a more credible monetary policy, making market expectations more responsive to signals from the central bank. Recently, both the Bank of England (1997) and the European Central Bank have been made independent and follow a set of published inflation targets so that markets know what to expect. Even the People's Bank of China has been accorded great latitude due to the difficulty of problems it faces, though in the People's Republic of China the official role of the bank remains that of a national bank rather than a central bank, underlined by the official refusal to "unpeg" the yuan or to revalue it "under pressure". The People's Bank of China's independence can thus be read more as independence from the USA which rules the financial markets, than from the Communist Party of China which rules the country. The fact that the Communist Party is not elected also relieves the pressure to please people, increasing its independence.

Governments generally have some degree of influence over even "independent" central banks; the aim of independence is primarily to prevent short-term interference. For example, the Board of Governors of the U.S. Federal Reserve are nominated by the President of the U.S. and confirmed by the Senate the Chairman and other Federal Reserve officials often testify before the Congress.

International organizations such as the World Bank, the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) are strong supporters of central bank independence. This results, in part, from a belief in the intrinsic merits of increased independence. The support for independence from the international organizations also derives partly from the connection between increased independence for the central bank and increased transparency in the policy-making process. The IMF's Financial Services Action Plan (FSAP) review self-assessment, for example, includes a number of questions about central bank independence in the transparency section. An independent central bank will score higher in the review than one that is not independent. (www.wikipedia.org , 2014).

1.15-Islamıc bank

1.15.1-Definition of Islamic bank:

An Islamic bank may be defined as a financial intermediary whose objectives and operations as well as principles and practices must conform to the principles of Islamic law sharia , and consequently , is conditioned to operate all it activities without interest (alam,2001).the aim of Islamic economics ,as observed by (molla et ,1998), is not only the elimination of interest based transactions but also the establishment of a just and balanced social order free from all kinds of exploitation.an Islamic bank is not only a financier but also a partner in business .the system essentially involves sharing of risk between the owner of capital and the entrepreneurs, as well as sharing the result of the collective efforts. Thus, it differs from an interest based system in which the risk is mainly borne by the entrepreneur or by the user capital. In other way we can call Islamic banking as participatory banking.

"Islamic banks are the cornerstones of the Islamic financial system and were the first financial institutions established under sharia principles". (Faleel jamaldeen, 2012, p.56)

The very basic difference between conventional bank and Islamic bank is this: Islamic banks are based on interest-free operations. (Faleel jamaldeen, 2012, p.56).

1.15.2-Permanent sources of Islamic bank:

1-Permanent sources of funds –internal:

Accumulated Profits (Retained Earnings)

► Capital Reserves

► Revenue Reserves

2-permenant sources of funds –external:

- Bank Accounts:

► Non-Profit Accounts or Current Accounts (Demand Deposits) Qard-e-Hassanah Deposits

► Profit Bearing (on Mudarabah basis)

– Savings Accounts

– Investments Accounts

External Qard-Hassan Deposits

► Like current account in conventional banks.

► Kept for safekeeping and convenience in payments (transfers)

► No return or profit offered

► Checkable

► Face value guaranteed by the ban

3-Permanent sources –profit bearing:

Savings Accounts

► Checkable just like conventional saving accounts

► the term to maturity is not fixed as in the case of term or fixed deposits

► can be assigned by the depositor to participate in productive activities, thus becoming PLS accounts (Mudarabah-based)

Investments Accounts:

► Investor committed for a certain time period

►usually not checkable.

►early withdrawal may be denied by the bank, but usually allowed as per the norms.

► usually there is a minimum period before which the withdrawal would result in denial of all profits.

► for the withdrawals made after the minimum period, the weightage is reduced accordingly.

1.15.3-Temporary sources of funds (liquidity management):

1-Special Mudarabah Portfolio:

► Islamic alternative to overnight lending and borrowing

►A separate portfolio is created by several banks jointly

Securitization:

► Islamic banks can securitize their assets (like real estate, Ijarah assets etc.) and raise the required funds

2-Salam:

► Islamic bank enters a contract with another financial institution agreeing to provide specified commodity to that institution in future and get the money now.

3-Tawarruq:

► Islamic bank purchases marketable (real) assets from the Financial Institution and sells it in the market to get funds

4-Back-to-back financing:

►If the bank has tight liquidity position it can direct the financing of a specific transaction to another bank.

1.15.4-Fee-based operations:

1-Islamic banks can charge fee for providing following services:

► Checking account

► Money transfers

► L/C (Non-funded)

► Lockers (safe-keeping)

►Online services

► Debit Card and ATM services

► Collections

► Investment banking services

► Cash and Portfolio management advice

► Brokerage services

Letter of Guarantee.

Fee for issuing Letter of Guarantee disallowed

► But the bank has the right to be reimbursed for expenses incurred in providing the Letter of Guarantee.

►The amount charged should be uniform if the expenses incurred are same across various guarantees provided.

1.15.5-Activities of Islamic Banks

Individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. In the following, we will describe the salient features common to all banks.

All the Islamic banks have three kinds of deposit accounts: current, savings and investment

1. Current accounts:

- Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.

2. Savings accounts:

- Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands.

3. Investment account:

- Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed. (http://www.financialislam.com , 2014).

SECOND CHAPTER

ISLAMIC BANKING

2. -INTRODUCTION:

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (sharia) and its practical application through the development of Islamic economies. Sharia prohibits the payment of fees for renting of money (Riba, usury) for specific terms, as well as investing in business that provide goods or services considered contrary to its principles (haram, forbidden) .while these principle were used as these basis for of lurching economy in earlier times, it is only in the late of twenty century that a number of Islamic banks were formed to apply these principles to private or semi-private commercial institutions within the Muslim community.

The definition of Islamic banking according to the organization of Islamic conference defined Islamic banking as “a financial institution whose statutes, rules, and producers expressly state its commitment to the principles of Islamic sharia and to the banning of the receipt and payment of interest on any of its operations”. (Ahmed, 2008, P.15).

Islamic banking is not totally different from conventional banking they are doing the same practice such as saving deposits and consumer finances but there are some fundamental difference of its practice and objectives. Islamic banking is interest free and its main objectives are the equal distribution of wealth, decreasing the poverty and increasing the investment opportunities. (Ahmad, 2008, p.16).The Islamic banking system put an emphasis on the non-payment of interest as well as partnership and risk sharing. Interest is guaranteed fixed and risk free rate of return. The Islamic banking system is built on a profit or loss system (PLS). (Björk, ludström, 2004, p.24).

2.1-History of Islamic Banking.

2.1.1-Classical Islamic banking:

The first modern experiment with Islamic banking was undertaken in Egypt under cover without projecting an Islamic image for fear being seen as a manifestation of Islamic fundamentalism that was anathema.

The political regime. The pioneer During Islamic banking golden age, early forms of proto capitalism and free markets were present in the caliphate, where an early market economy and a nearly of mercantilism were developed .between the 18^{th} -12^{th} centuries, which some refer to an “Islamic capitalism”.

A Vigorous monetary economy was created on the basis of the basis of the expending level of a stable high value currency (the dinar) and the integration of monetary areas that were previously independent.

Riba, The definition of riba in classical Islamic banking jurisprudence was surplus. Value without counterpart “or to insure equivalency in real value” and that “numerical value was Immaterial” during this period, gold and silver currencies were the bench mark metals that defined that value of all materials being traded. Applying interest to the bench mark itself (exnaturasua) made on logical sense as its value.

Reminded constant relative to all other materials:

These metals could be added to but not to create (from nothing).Applying interest was acceptable under some circumstances. Currencies that were based on guarantees by a government to honor the stated value (i.e. fiat currency) or based on other materials such as paper on base metals were allowed to have interest applied to them. Where base metal currencies were first introduced in the Islamic world, not just ever thought that paying a debt in a higher number of unites of this fiat money was Riba. As they were concerned with real value of money (determined by weight only) rather than numerical value .for example, it was acceptable 100 gold dinars to pay back as 1050 dinars of equal aggregate weight (i.e. the value in terms of weight had to be same because all makes of coins did not Carrey exactly similar weight).

2.1.2-Modern Islamic banking:

Islamic banking effort, led by Ahmad ALnaggar, took the form of saving based on profit sharing Egyptian town of Mit Ghamr 1963.This experiment lasted until 1967 (ready1981) by which time there were nine such bank in this country.

In 1972,the Mit Ghamr savings project became part of Nasr social bank which till date , is still in business in Egypt in 1975, the Islamic development bank was set up with the mission to provide funding the projects I the members countries.

The first modern commercial Islamic bank, Dubai Islamic bank opened its doors in 1975.in the early years, the products offered were basic and strongly founded in conventional banking products, but in last few years the industry is staring to see strong development in new products and services. Islamic banking is growing at a rate of 10-15% per year and with signs of consistent future growth. Islamic banks have more than 300 mutual funds that comply the Islamic principles.

The relative stability of Islamic banking institutions in current recession has gained it attention. Even the vacation said the bank should look at the rules of Islamic finance to restore confidence, held annually in Bahrain since 1994,is internationally recognized as the largest and most significant gathering of Islamic banking and finance leaders in the world.

2.2-Principles of Islamic banking:

The principles of Islamic banking are based on Islamic law, known as sharia which mean:

1-**interest (Riba):**

Interest cannot be paid or received on transaction in any case where money is exchange for money because the money is not actually any value accordance to Islam if it is not employed in business (Ahmad, 2008, p.17).

Prohibition of riba (interest).

Many Muslims scholars and some western thoughts believe and still considering that just interest free banking is an Islamic banking. Actually interest is fully prohibited in Islam that is proved in Quran and sunneh.

“The interest that you give in order to increase in the wealth of people, does not increase in the sight of Allah; and zakat that you pay in order to win

Allah’s approval, its payers do indeed increase their wealth”(surah AL Rome , no.39).

It is beautiful and powerful statement from Quran which shows the interest is prohibited by god because it can only increase the wealth of individual not the society. (Ahmad, 2008, p.17).

2-Ghara and maysir.

Transactions must avoid uncertainty (Gharar), speculation (maysir) or anything that could lead to the unjust enrichment or unfair exploitation the big investors and industrial lists turn the economic financial system toward their own and personal benefits. (Ahmad, 2008, p.17).

3-unethical business:

Transaction cannot be made that involve prohibited products or activities, such as alcohol, illicit drugs and tobacco because Islam wants to develop an ethical and friendly environment in the society. (Ahmed, 2008, p.17).

2.3-Difference between Conventional and Islamic Banking:

Conventional Banking	**Islamic Banking**
Money: is a commodity besides medium of exchange and store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.	**Money:** is not commodity though it used as a medium of exchange and store of value. Therefore, it cannot be sold at price higher than its face value or rented out.
Time value is basis for charging interest on capital Interest is charged even in case. The organization suffers losses by using bank funds. Therefore, it is not based on profit and loss sharing	Profit on trade of goods or on providing service is the basis for earing profit. Islamic bank operates on the basis of profit and loss sharing incase, the businessman has suffered losses. The bank will share these losses based on the made of finance used (Mudarabah, Musharakah).

Main Principle: The customer obtains fixed interest from the banks and does not share the loss (Al-Rifaee, P21)	**Main Principle:** The customer shares the profit and loss with the bank. High degree of risk with variable returns.
Stability: lower degree of stability	**Stability:** higher degree of stability
Treatment of Interest: interest based on products	**Treatment of Interest:** use profit and loss structure (PLS) accounts. Interest is prohibited
Profitability: Higher connection leads to higher interest rates which leads to higher profitability. Higher rates of inflation leads to higher profit margins	**Profitability:** PLS is based on partnership (Musharakah) or joint investment without participation in management (Mudarabah) based markup principles leasing contrast (Ijara)
Conventional banks use money as a commodity which lead to Inflation	Islamic banking tends to create link with real sectors of the economic system by using trade related activities. Since the money is linked with the real assets therefore, it contributes directly in the economic development.
Under conventional mortgage, in order to purchase a property the customer borrows money and repays it with and additional amount over a period of time. The additional amount is the amount of interest which is against the sharia rulings of Islam. (www.mib.com.mv, 25/6/2014).	Under Islamic mortgage finance facility, Islamic bank shares with the customer in purchasing his descried property in proportion to their share in purchasing the property. (www.mib.com.mv, 5/26/2104)

2.4-Challenges facing Islamic Banking

1. Increased competition.
2. Building bridges and strategic alliances.
3. Need to increase the size of Islamic banks.
4. Financial engineering.
5. Sharia aspects.
6. Teaching, training, researched and development.
7. Need for diversification in the use of Islamic modes of finance
8. Need for establishing equity institutions.
9. Establishment of secondary markets and interbank market
10. Appropriate legal frame work and supporting polices and producers.

1) Increased competition

So far, Islamic banks have had a fairy large degree of “monopoly” over the financial resources of the Islamically motivated public. This situation is changing fast.

Islamic banks are now facing ever-increasing competition an important development in Islamic banking in the last few years has been the entry of some conventional banks certainty how many conventional banks around the globe practice Islamic banking techniques, even a randomly selected short list may contain some of the giants of international banking business such as Citibank, chase Manhattan and Abc international in addition to these several commercial banks are offering Islamic banking services in many Muslim countries. Bank Misr in Egypt and national commercial bank in Saudi Arabia have opened Islamic branches.

This development is a clear recognition of the viability of Islamic banking as an alternative model, but has at the same time increased competition. Therefore, the survival of Islamic bank essentially on their own efficiency and performance.

2) Building bridges and strategic alliances

The competition from conventional banks is expected to increase further in the near future due to globalization. Due to liberalization, world markets are rapidly converging into single market place to benefit from the opportunities offered by globalization.

Islamic banks need to improve the quality of their services and develop suitable products.

Technological innovations are also playing an important part in financial integration and globalization.

Electronic banking and the widespread use of computers in banking have transformed the way banking is alone.

The communication revolution through electronic correspondence has reduced the cost of international communication.

The globalization of financial markets has led to a greater and greater integration of capital markets. The liberalization of foreign exchange markets has further reinforced this trend. Paper currency is being replaced with plastic cards and electronic ledgers are replacing accounts books. The sowing of one country can now be invested in other countries by the click of mouse.

The day is not far away when customers well be able to “navigate” on the internet between competing banks, unit trusts, mutual funds and even business firms.

Islamic banks cannot remain aloof to these developments they must carefully watch these developments and adjust their strategies accordingly in order to operate in global markets, they have to form strategic alliances with other banks. It will also be useful to build bridges between existing Islamic banks and those conventional banks.

That are interested doing banking on Islamic principles. Such strategic alliances will benefit both sides.

Islamic banks will benefit as the western banks bring their efficiency, market research, innovative capabilities, sophisticated banking and result oriented approach to Islamic banking, which may lead to the development of new products and the provision of better services to consumers on the other hand, the conventional banks will benefit from the indigenous infrastructure closure consumer contacts, and Islamic credentials of Islamic banks.

It may be worthwhile to paint out here that there are some genuine concerns about the operations of large multinational banks in Islamic banking practices. Naturally, their motives are purely commercial: they view it as a lucrative business opportunity. That is fair enough. However, doubts have by rules of the game and whether they are able to follow the percepts of Islamic banking correctly.

In all major Islamic banks, there's a sharia board which regularly reviews the operations and contracts of the bank to determine their compliance with the requirements of the sharia. Such elaborate arrangements do not exist in conventional western banks in most cases. Even if some of them have sharia advisors, a credibility gap remains.

Alliances with well-established Islamic banks might help remove this gap. Irrespective of whether these doubts are in fact true are not. Common perceptions have important implications for business. Conventional banks stand to benefit significantly in this respect by working together with Islamic banks. (Al-Omar, Iqbal, 2011, p.3)

According to the researcher Islamic banks are facing competition with conventional banks because of new the Islamic banks and should develop her technological to face the competition with conventional bank.

3) Sharia aspects

Because of the religious of Islamic banking and finance, no new product can be adopted until it is cleared by sharia scholars.

Even after a new product is put into use, sharia auditing of the operations of financial institutions is very important to ensure that the actual practice complies with the requirements of sharia. This important not only for religious reasons but also for purely business considerations because the client of Islamic banks will not have confidence in their operations unless sharia scholars clear their activities. With this backdrop in mind, the expertise of Fiqh scholars in understanding the prerequisites of modern financial products and in evaluating these products becomes very important.

All most all Islamic banks have their own sharia boards or sharia advisers. A survey of the members of these boards would reveal the hardly any of these scholars has formal training in modern finance. This puts a serious constraint on the ability of sharia scholars to issue well informed rulings on financial products activities. The sharia scholars are themselves conscious of this difficulty. They are using a number of ways to acquire the necessary background in formation before issuing a fatwa. One of these ways is to discuss an issue in meetings or workshop attended by both sharia scholars and financial experts. Institutions such as the Islamic research and training institute and Islamic universities are playing an active role in organizing such workshops.

However, these workshops have no mandate to issue a fatwa. For this purpose, the meetings of Fiqh academies, the most prominent among which is the OIC Fiqh academy in Jeddah, play a more important role. These academies also commission a number of studies by specialized experts on specific issues before discussing them and making a decision. In the absence of the required expertise in the field of finance among sharia scholars, this approach of group ijtihad or "ijma" is playing an important role in safeguarding against serious mistakes in adopting doubtful instruments.

This situation is, however, far from ideal. As any participant of the workshop and meetings of Fiqh academies can easily notice, the interaction between Fiqh scholars and experts of modern economics and finance does not proceed smoothly. The two groups have such different background and speak such different technical languages that communication between them is very difficult. It is therefore understandable that sharia scholars are cautious in giving rulings. As a result, the decision-making process has become very slow and trends to be over-concentrative.

The past record shows the sharia bodies have done a commendable job in evaluating the applications of traditional contracts and safeguarding against the use of some and the misuse of other. When it comes to evaluating modern financial contracts or Islamic substitutes for them. However, sharia bodies have found it quite working knowledge of both modern finance and sharia.

4) Teaching, Training, Research and Development

Teaching, Training and Research are the wherewithal for the development of any discipline. This is all the more so far a discipline like Islamic banking and finance that is still nascent. As mentioned above, there is a serious shortage of scholars who process even a working knowledge of both Islamic Fiqh and modern economics and finance. Unfortunately, very little effort has been made to meet these requirements in the area of teaching, Islamic universities in some Muslim Countries, particularly Pakistan and Malaysia have initiated some teaching programs to produce graduates with this dual specialization.

However, a close examination of their curricula would reveal that they are not well designed to achieve this objective. This may also be confirmed by the fact that the Islamic banks have not been able to find areas anable number of suitable managers from the graduates of these universities, nor could anyone of them find a place in the sharia board of any Islamic bank. Similarly, hardly any of the graduates of these universities has produced any research that has found far or in practice in the area of research, neither Islamic banks as group nor any of the individually spend any sizable founds on research. Some Islamic banks have small unit for research, but none of this research activity is designed to ward product development. It is therefore not surprising that the speed of development of new financial products within the Islamic banking industry is very slow. Islamic universities and the few research institutions working here and there have not received any financial assistance from Islamic banks, nor has there been any coordination between Islamic banks and the seats of higher for any worthwhile research project.

Another very important component of useful and scientific research is the availability of authentic information. This has not received much attention from Islamic banks. Some attempts have been made in this regard but have not received active support, either financial or otherwise, from Islamic banks. As a result, there is no consistent data series on the activities of Islamic banks for a reasonable number of years available anywhere.

Whatever little information is available is also subject to number of qualifications.

In the area of training, a small effort was made in 1970's by establishing a training institute in Cyprus.

Due to certain reason, this institute has been closed. The managers of Islamic banks may be attending short-term courses either on the job or elsewhere, but there are no many formal training programs meant to prepare the employees of Islamic bank for the needs of the system. Most of the employees of Islamic banks, including their managers and financial experts. Come form conventional environments and lack the necessary expertise in and commitment to Islamic bank. As institution is what it employs make it. It is therefore extremely important to have people with the right kind of skills and commitment to run Islamic banks. (Al-Omar, M. Iqbal, 2011, p.12).

5) Establishment of Secondary Markets and Interbank Market

Banking thrives on the existence of a secondary financial market. Commercial banks invest in very short term securities which they can convert into cash very quickly at negligible conversion cost. There are several ingredients of a secondary financial market: securities, dealers and financial institutions.

Various kinds of securities such as bonds, shares, debentures, commercial papers are the financial instruments. Merchant banks, investment banks, mutual funds, investment funds, etc. are the financial establishing and/or strengthening secondary markets.

Most Islamic banks exist as single entities. The strength of commercial banking is derived not form individual institutions but by taking all banks together.

Interbank transaction among Islamic banks are minimal because in most countries the number of Islamic banks is very small. The evolution of short-term financial assets that Islamic bank may hold and transact among themselves shall go a long way toward making on Islamic money market a reality.

Islamic banks lack such short-term instruments in which they can profitably invest for very short periods. Modern commercial banks can lend each other millions of dollars even for a day. They can also calculate interest on a per day basis. An Islamic alternative to the very short-term placement of funds has yet to evolve. (Al-Omar, Iqbal, 1998, p.9).

6) Appropriate Legal Frame Work and Supporting Polices and Producers

The commercial, banking and company laws in most Islamic countries are fashioned on the western pattern. Hence these laws may contain provision that are in conflict with Islamic banking methods. Even if parties structure their agreements according to Islamic contract. The laws that govern the interpretation and enforcement of these agreements usually are wholly ignorant of this farm. His simply impractical for parties to incorporate into their agreements all the relevant Islamic rules, making Islamic contracts more costly to conclude. In case any disputes arise, the local laws will usually be enforced which in many cases would involve the violation of some Islamic rules. One of the most serious problems is the lack of a proper legal from work to deal with cases of delayed payments and bad loons. These conditions, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place. It should also be mentioned that the successful operation and healthy growth of Islamic banking requires not only an appropriate institutional framework but also a correct policy-mix from the government. Muslim governments need to do more to create a more congenial environment for Islamic banks. In many cases there are practical obstacles in the way of Islamic banking structural adjustment.

Particularly in fiscal and monetary areas, are needed to provide Islamic banking enough room to operate effectively.

A- Supervisory From work

The supervision of Islamic banks as important as the conventional banks. There are three main reasons why the regulation and supervision of banking industry are important:

1- To increase the information available to investors.
2- To ensure the soundness of the financial system.
3- To improve control of monetary policy.

Most Islamic banks in the contemporary world operate function side with Islamic banks.

The central banks subject Islamic banks to the same controls conditions, and regulations that they apply to interest based banks. As long as the instrument of regulation and control used by the central banks remain free of interest "no object" or may be advanced against them at least on Islamic grounds. There are certain factors, however, that require that Islamic banks be treated on a different footing same of these. Factors are the following:

1) Islamic banks, like all other commercial, are required to keep some of their deposits with central banks.

Central banks usually pay interest on these deposits which Islamic bank cannot accept. An alternative is needed to ensure that Islamic bank get a fair return on their deposits with the central banks.

2) Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most Islamic banks function under the supervision of central bank. They cannot benefit from such a facility because funds are usually provided on the basis of interest.

3) Legal reserves imposed on deposits with conventional banks are meant to meet possible with drawls whose rates vary between demand, savings and time deposits. This may apply to the same extent to Islamic banks, however, are of only in the case of demand deposits.

The saving and investment deposits of Islamic banks, however, are of such a nurture that with drawl before their term is not as common as in conventional banks. They must therefore be subjected to reserve requirements at ratios lower than those imposed on their counterparts with conventional banks.

4) Islamic banks do not enjoy the stability provided by deposits insurance. In most developed countries, the deposits of commercial banks are not insured. Hence a deposits at an Islamic bank bears a greater risk in the sense that if an Islamic bank collapse then the depositors will lose all their money because deposits are not insured.

It is true that Islamic banking is based on concept of Mudaraba, where the provider if the capital (Rab Al-Mal) has to bear all the loss in the case that the business venture in which Mudaraba funds are invested fails. Under such circumstances, one may argue that any insurance scheme would be against the very idea of Islamic banking. However, nobody would argue that Islamic banks should expose themselves as well as their depositors to unnecessary risks that can otherwise be taken care of. In fact, the very fact that other commercial banks, which operate in the market, have deposit insurance puts Islamic banks at a disadvantaged position when it comes to competition between conventional and Islamic banks.

5) In countries where the central bank conducts open markets operations, Islamic banks are not able to participate in these operations because of the interest based nature of securities bought and sold.

6) A lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for the rather in appropriate policies of central banks to ward Islamic banks. This is particularly true of Musharaka and Mudaraba.

   In debt financing, the grating of a loon by a bank is a onetime activity, no matter what is size of the loon. But Musharaka and Mudaraba are ongoing activities, and the participation of an Islamic bank in these activities countries as long as the project financed is in operation. This is may have important implications for the reporting as well as control and regulation of Islamic banks by central banks.

B- Accounting Standers

Islamic banks function in different types of social environments and heterogeneous economic milieu. They have to put up with different types of official requirement regarding accounting practices. Among different Islamic banks, to the extent that any meaningful comparison between the balance sheets or profit and loss accounts of two different Islamic banks becomes a very difficult task if not an altogether impossible one. Furthermore, the concepts used in the balance sheets or profit and loss statements are not rigorously defined. During the last few years some headway had been made to overcome this problem. In order to introduce standardization in the accounting practice of Islamic financial institutions, some Islamic banks have under the guidance of the Islamic development bank established a technical cum juridical organization called “Accounting and Auditing Organization for Islamic Financial Institutions” (AAOIFI). The organization now functional and based in Bahrain, is composed of a supervisory committee and a financial accounting standards Beard responsible for preparing, issuing and amending the accounting standards of these Islamic bank and financial institutions that have agreed to apply the standards setup by the board. However, it will be sometime before any perceptive change in the accounting practices if Islamic banks is observed unless the banks pay more attention to this aspect.

THIRD CHAPTER

ISLAMIC FINANCE INSTRUMENTS

3. INTRODUCTION

Islamic banks are entities that perform financial intermediation according to the routings of Sharia. Collection of deposits and utilization of credits make Islamic banks similar to Conventional banks.

The Risks exposed by Islamic banks to customers and to financial system are also very similar. However the unique nature of Products differentiates Islamic bank in many aspects.

Exclusion of interest, Prohibition of making money from money, implementation of Profit and loss sharing system and Prohibition against excessive uncertainty are main sources of difference associated with Islamic banks. The types and extend of risks differ in great extent. Islamic banking concept was initiated about three decades ago, Today Islamic banks are established in 19 countries.

The countries include Bahrain, Egypt, Indonesia, Iran, Jordan, Kuwait, Sudan and United Arab Emirates. Most of these countries include conventional banks side by side with Islamic banks. In fact only countries that have adapted the Islamic banking principles for entire financial system are Iran and Sudan with Pakistan in Process. (Kabir Hassan, Dicle, 2011, p.282).

3.1-Islamic Finance Instruments (modes of operation).

- The main Principles of Islamic finance include the following:

1. Strict Prohibition on paying or receiving interest
2. Risks in any transaction must be shared between the parties, so that the provider of Capital and the entrepreneur share the business risk in return for a share in the Profits;

3. Speculative behavior is prohibited. This means that extreme or excessive uncertainty (ghasas) or risk is prohibited, and thus contractual obligations and disclosure of information are necessary.
4. Money is seen as potential capital and can only take the form of actual capital when it is used in productive capacity, or combined with labor
5. Every economic activity is permissible unless explicitly Prohibited by sharia which includes injections contained in, or derived from The Quran and The Sunnah.

All the financial Islamic instruments are based on sharia compliant contracts and techniques, and they all serve customers' needs in the real world. Islamic banks use this products to serve the markets and the communities in which they operate.

Islamic banks support all sorts of economic activity. Here's just a taste of how these instruments intersect with customer's needs.

1- Customer Financing, including short term personal and corporate financing is possible using tawarruq, murabaha and qard Hasan contract.
2- Red estate Financing occurs via musharaka, diminishing, murabaha, bay al-muajil, ijara and istisna contracts.
3- Auto Financing depends on financial instruments supported by murabaha, ijara, musharaka and bay al-muajil Contacts.
4- Credit Cards, are available thanks to tawarruq, and their service charges are possible because of ujra and ijara contracts.
5- Financing for international trade is available courtesy of mudarabah contracts.

3.1.1. Sharing the Profit and Loss with Venture Capital (Mudaraba)

This Product is one of the most widely used financial instrument in the Islamic banking sector.

A mudaraba Contract is based on partnership in which one partner is the financer (the Investor) and the other Partner (the Fund Manager) manages the financer's investment in an economic activity. The second partner (often the entrepreneur) has expertise in applying the venture capital into the economic activities.
Both of Parties agree in advance to profit and loss sharing (PLS) ratio.

In Arabic, The investor is called (Rab Al-Mal), and the Fund Manager is called (mudarib).

The mudaraba Contract dates back to the early days of Islam, The prophet Muhammad (pbuh) acted as Fund Manager (mudarib) for his wife who was the investor (Rab Al-Mal). For several trades. His wife provided the capital and shared the profit with the prophet (pbuh).

- In this contract, the basic factors of Production (From the Islamic Economics Viewpoint).
- Capital, labor and entrepreneur are combined to make an economic activity. The Rab Al-mal provides the capital and the mudarib provides entrepreneurship and labor

The mudarib gets a partition of the profit for his effort and the Rab almal gets the remaining profits.

All mudaraba Contacts are limited by a specific time period.

They don't continue indefinitely.

3.1.1.1. Types of Mudaraba Contracts

According to the Rab Almal can chose which types he wants to invest.

There's two types of mudaraba Contracts:

3.1.1.1.1. Restricted Mudaraba (Mudaraba Al-Muqayyadah):

The Investor specifies a particular Business or Project where the investment Funds are to be used, the working partner should not use the funds for any other Business or Project.

3.1.1.1.2. Unrestricted Mudaraba (Mudaraba Al-Mutlaqah):

In this mudaraba contract, the investor gives the working partner permission to funnel the funds into any type of Business or Project that best suits the financial goals of both Partners.

When a mudaraba contract is used as a source of bank funds (when the customer deposits money in the bank), the unrestricted mudaraba is most often used. When the contract support a bank's equity financial product (when the bank supplies funds to a working partner), the restricted mudaraba is most often in play.

3.1.1.2. Dividing the Spoils

With mudaraba contracts, the Rab almal and the mudarib share profits and losses based on an agreed upon ratio. The mudarib (manager or working partner) also receives a fixed fee for managing the project in additional to share of any profits.

3.1.1.3. First-tier and two-tier mudaraba:

Using mudaraba as a source of funds, the mudaraba contract is applied when someone deposits money in an Islamic bank with the expectation of getting a return. In most cases, the contract applied is a first-tier (or sample) mudaraba contract, meaning that only the customer and the bank are involved. (The bank serves as fund manager for whatever money is deposited).

However, another type of contract exists a two-tier (or intermediary) mudaraba contract. In this case, the bank acts as an intermediary (Rab almal and mudarib) between the investor (Rab almal) and the entrepreneur (mudarib).

Islamic scholars promote using this kind of mudaraba made in two type's scenarios:

1. The bank and its own doesn't have the capacity to serve as the investor (the Rab almal). This scenario (type) may mean that the bank doesn't have enough liquidity to enter a mudaraba contract with an entrepreneur or fund manager.
2. The bank lacks the Expertise to serve as the fund manager (mudarib) for an investment.

In both cases, the two-tier contract allows the bank to create a link between investors and expert fund manager or entrepreneur so the economic activity can take place.

- The two-tier method of mudaraba is a less frequently applied than the first-tier method. That's because banks usually have the liquidity and/or expertise to enter into a first-tier contract because the two-tier method isn't quite as profitable for the bank as the first-tier method.(Jamal deen, 2012, P.149)

3.1.2. Musharaka (Supporting Joint Venture).

The second kind of equity participation financial instrument used by Islamic banks is based on a musharaka contract. It established a partnership or joint venture for an economic activity between the bank and one or more clients. In this joint venture, all parties may contribute some (not necessarily equal) percentage of all three factors of economic production (capital, labor and Entrepreneurship).

- In a mudaraba contract, one party is a financier (silent partner), and the other party (working partner) provides labor and entrepreneurship. But in a musharaka contracts, all participants are working partners. (Jamal deen, 2011, P.151).

According to the researcher Habib Anwar "The literal meaning of musharaka is sharing". In Islamic jurisprudence, musharaka means a joint enterprise formed for conducting some business in which all partners share profits according to a specific ratio, while the loss is shared according to the ratio of their contribution. It is an ideal alternative for interest based financing with far reaching effects on both production and distribution. (Anwar, 2008, P.14).

3.1.2.1. The Key Feature of Musharaka:

1. The ratio of profit Distribution may differ from the ratio of instrument in the total capital, but the loss must be divided exactly in accordance with ratio of capital invested by each of the partners
2. Capital that is invested by the partners can be unequal and should preferably by in the nature of currency. The market value would be determined with mutual constant to determine the share of each partners. It may also be in the form of equal unites representing currency called "shares", and the intended partners may buy these shares disproportionately.
3. It is not allowed to fit a return or lump amount for any of the partners, or any rate of profit tied up with any partner's investment
4. The liability of the partners in musharaka us normally unlimited.

There face if the liabilities of the business exceed its assets and the business goes into liquidation, all the exceeding liabilities shall be borne pro rate by all the partners.

However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the excess liabilities shall be borne by that partner alone who has incurred a debt.

Musharaka according to Dr. Rajeev Jain, musharaka, it's a relationship between parties, both of which contribute capital to a business and share in its management. Partners in musharaka may appoint one or more of them or a third party to carry out the management on their behalf profit is divided according to a pre -agreed profit-sharing ratio and loss is shared pro ratio.(Rajeev Jain, Islamic banking, 10-8-2014).

3.1.2.2. Consecutive and Declining Balance Partnership:

Islamic banks divide musharaka into two categories based on the retention of partners in joint venture

(How long the partners will stay in the joint venture):

3.1.2.2.1. Consecutive Partnership (Consecutive Musharaka):

Each partner can keep its share in the partnership until the very end of the joint venture, project or business.

However, the partners are often allowed to withdraw or transfer their shares (unless the initial contract specifically states that all partners shall remain in the partnership until the date of maturity). If one of the partners withdraws for the contract the whole partnership doesn't terminate.

3.1.2.2.2. Declining Balance Partnership (Diminishing Musharaka):

One partner is allowed to buy the other partner's share of equity step by stop until the whole equity of the other partner is transferred. It's called a declining balance partnership because one partner's equity balance declines gradually.

(Jamal Deen, 2012, p.151) according to the previous

Diminishing musharaka (Shirkah Al-Mutanaqisah) is type of Shirkah where one partner purchases the other partner's share gradually.

3.1.2.3. Features of Diminishing Musharaka:

In diminishing musharaka two partners start business in shirkah to earn profit. One of the partners undertakes to purchase the share of another partner gradually every month or each year.

3.1.2.4. Rules of Diminishing Musharaka:

1. There will be an agreement of diminishing between both partners where in investment of everyone and ratio of profit well be agreed.
2. One partner undertakes to purchase the share of other partners, but three conditions should be considered in this undertaking:
    - **a)** This promise will not be a part of shirkah agreement

b) The price of unit will not be agreed in this promise, but promise to purchase should be at market value at the time of purchasing
c) If promise is not fulfilled, them it can be forced by court of law

3. At the time of purchase, the price of unit will be decided on the basis of market value of business.
4. Unit will be purchased through Offer and Acceptance.

3.1.3. Making Purchases with Cost plus Profit Contracts (Murabaha):

In the kind of agreement, a commodity is sold for cost plus profit, and both of buyer and seller know the cost and the profit involved. Basically, this product is a kind of trade financing instrument used by Islamic banks. (Jamal Deen, 2012, P.153).

Definition if murabaha is a very popular contract in Islamic finance, especially for the buying of commodities involving large sums of money where the client is unable to pay in advance or when the commodities suppliers doesn't trust in client. It is sharia compliant because there is no interest rate on a differed payment the financial institution gives to the client. (http://lexicon.ft.com/Term?term=murabaha , 17-8-2014, 5:08AM).

In Islamic finance, a sales contract where the bank buys a product on behalf of a client and resells the product and the margin or the mark-up when reselling the product to the client. Usually the bank pays for the product in full and allows the client to pay the bank back in installments. So, instead of having a classic loan as in conventional finance when the bank lends money to the client to buy products, in the murabaha case, the financial institution buys and resells the product with a mark-up to the client. (http://lexicon.ft.com/Term?term=murabaha , 17-8-2014).

3.1.3.1. Murabaha Basics:

Under murabaha contract, a bank purchases a commodity in order to supply it a customer who isn't financially able to make such as a purchase directly. The bank sells the commodity to the customer for the cost plus profit – the profit being a markup that both the bank and customer agree on upfront.

The customer can make a lump payment when the commodity is delivered but usually sets up a deferred payment installment schedule. (Jamal Deen, 2012, p.154).

For example: say a manufacturer wants to buy $100,000 worth of wood but doesn't have enough funds.

The manufacturer approaches the bank and signs an agreement to purchase the wood from the bank at cost $100,000 plus profit (maybe 20 percent of the contract amount or $20,000).The manufacturer is liable to pay the bank $120,000 after the bank delivers the goods. Both parties know the profit and cost of product at the onset. There's no financial uncertainty in the transaction. (Jamal Deen, 2012, p.154).

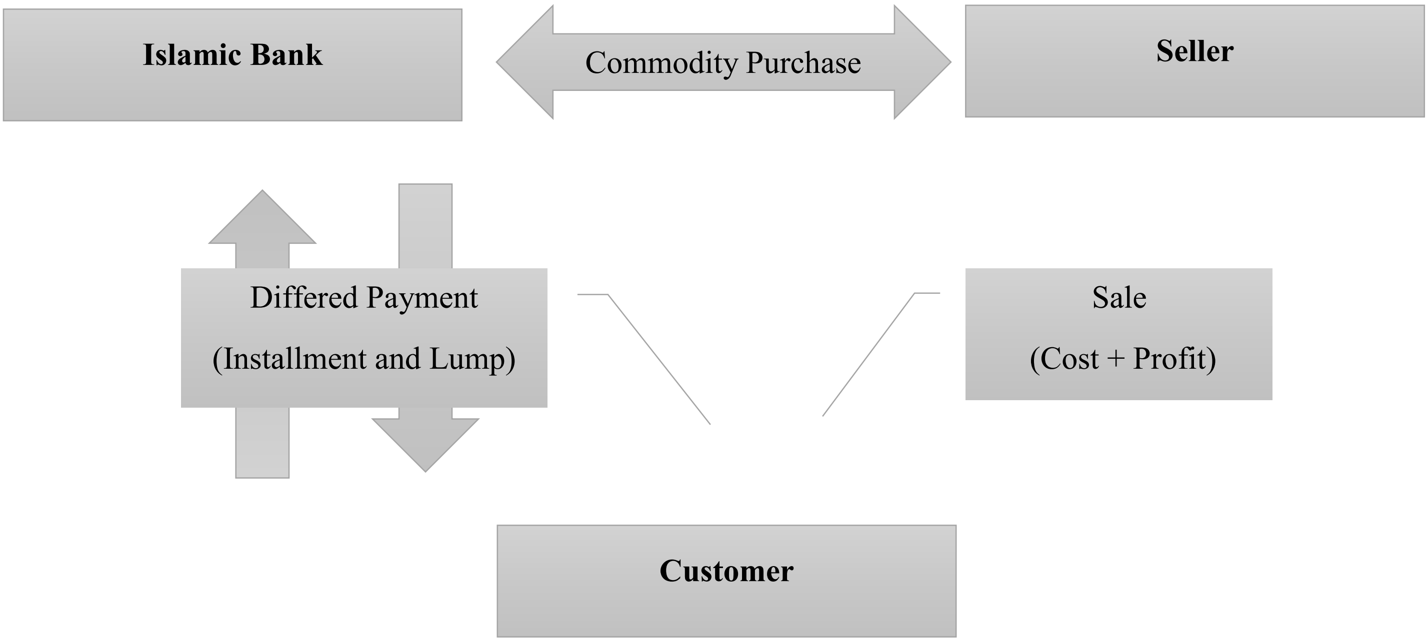

Diagram.3.1.Murabaha basic (Jamal Deen, 2012:115)

3.1.3.2. The Murabaha Contract is a Basic Sale Transaction and Certain Rules Need to be followed to Make Sure it's Sharia Compliant:

1. If the client defaults on the payment, the financer isn't allowed to change extra fees as late payment or penalty charges.
   Sharia scholars allow changing additional fees in cases of loss or damage due to a client's default, and they allow certain penalties cannot be treated as income for the bank; they must be given to charity.
2. The contract should be used only for purchases. It's not intended to be used for financing a working capital requirement.

3.1.3.3. Types of Murabaha Contracts an Islamic bank may offer:

1. **Murabaha to the purchase order:** In this contract, the bank specifically purchases the assets for the client's order.
   The client request that the bank purchase the goods on her behalf, and she agree to buy the goods from the bank.
2. **Commodity murabaha:** The commodity murabaha is used as an instrument in Islamic interbank transaction.
   Generally, this financial instrument is used to fund the Islamic bank's short term liquidity requirement.
   This product was developed as an alternative to conventional interbank funding.

Commodities such as gold, silver, barley, salt, wheat and dates, which are used as mediums of exchange aren't allowed to be traded under the commodity murabaha contract.

3.1.4. Reverse Murabaha (Tawarruq):

Tawarruq is financial instrument in which a buyer purchases a commodity from a seller on a deferred payment basis, and the buyer sells the same commodity to third party on a spot payment basis (meaning the payment is made the spot). The buyer basically borrows the cash needed to make the initial purchase. Later, when he secures the cash from the second transaction, the buyer pays the original seller the installment or lump payment sum payment he owes (which is cost plus markup, or murabaha).

Because the buyer has a contract for murabaha transaction, and later the same transaction is reversed. The scenario is called a reverse murabaha. Both transaction involved must be sharia compliant. (Jamal Deen, 2012, p.156).

Tawarruq is a somewhat controversial product. Because the intention of the commodity purchases isn't for the buyer's use or ownership, certain scholars believe that transaction aren't sharia compliant.

Their argument is that the absence of any real economic activities creates interest, which is prohibited in sharia scholars who accept this contract as valid not that it is based on two valid legal contract, murabaha and sales.

Generally, commodities such as gold, silver, barley, salt, wheat and dates aren't allowed in tawarruq.

3.1.4.1. How does Tawarruq Work in Matter of Personal Finance?

- First, the customer purchases a commodity from the bank on a cost plus profit basis.
- Then the customer sells that commodity to a third party.
  (In reality, the customer simply authorizes the bank to sell the commodity to the third party on his behalf).
- The proceed from the sale are credited to the customer's account, and the customer pays back the bank
  (The cost plus profit).

This Figure for an illustration of this process

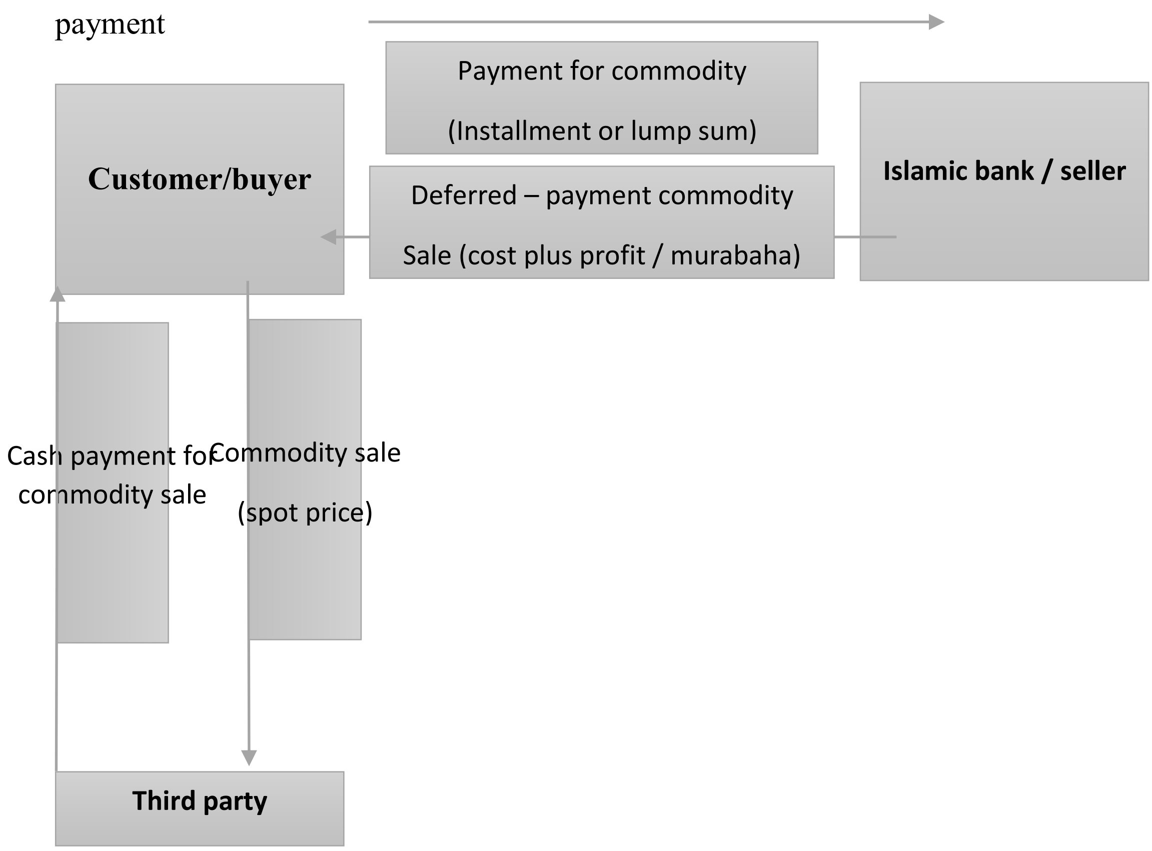

Diagram.3.2. How does Tawarruq Work in Matter of Personal Finance. (Jamal Deen, 2012, p.157).

According to the previous we can defined tawarruq:

Tawarruq, Spot murabaha contract, and we called in this name to distinguish between murabaha and tawarruq itself, which in tawarruq we have the goods because we need good not the needs of money.

3.1.5. Leasing or Renting (Ijarah):

The Arabic term Ijara mean's providing services and goods temporarily for a wage. As you may guess, involves providing products or services on a lease or rental basis. In the Ijara contract, a person or party is given the right to use the object (the Usufruct) for a period time, the owner retains the ownership of the assets. (Jamal Al-Deen, 2011, p.157).

Another definition for ijara, literally, means to give something on rent. As a term of Islamic fiqh, Ijara can also refer to wages paid to a person in consideration of the service ended by him. In the context of Islamic banking, Ijara can be defined as a process by which the "usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her".

(*www.meritresearchjournals.org*, Economics and Finance vol.2 (1) PR 001-007, January, 2014, p.2).According to the previous we can definition the term of Ijarah in Arabic literally means to give something on rent.

Ijarah contract is an agreement where in a lessor (mu`ajjir) leases physical asset or property to a lessee (must`ajir) who receives the benefits associated with ownership of the asset against payment of predetermıned rentals (ujrah).

Ijarah is for a known time period called Ijara period.

The Ijara contract is similar to a conventional lease in which the owner rents or leases his property or goods to lessee for a specified number of periods for a fee.

For example, the lessee is responsible for normal maintenance, and the lessor is responsible for major maintenance, just as with many conventional lease contracts.

3.1.5.1. The features of Ijara in Islamic banking which differentiate it from a conventional leases:

1. The leaser must own the assets for the full lease period.

2. If the lessee defaults on payments or delays payments, the lessor can't charge compound interest.

3. The leased asset's use in the contract.

3.1.5.2. Types or Ijara Arrangement Can Exist According to Sharia Principles:

1. Lease-ending ownership / lease with ownership
2. Operating lease (operating Ijara)
3. Forward lease (Ijara mawsoofa bi thimma).

1- Lease-ending ownership / lease with ownership

- In this contract, the lessee owns the leased asset at the end of lease period.
- This lease contract doesn't contain any promise to buy or sell the assets, but the bank may offer a (verbal) unilateral promise of transfer of ownership or offer a purchase schedule for the asset.(Jamal Al-Deen, 2011, p.157)

2- Operating lease (operating Ijara)

This type of Ijara contract doesn't include the promise to purchase the asset at the end of the contract.

Basically this setup is a wire arrangement with the lessor. (Jamal Al-Deen, 2011, p.157)

3- Forward lease

This contract is a combination of construction finance and a redeemable leasing agreement. Because this lease is executed for a future date, it's called forward leasing. The forward leasing contract buys out the project (generally a construction project) as a whole at its completion or in tranches (portions) of the project. (Jamal Al-Deem, 2011, p.158).

3.1.6. Financing Construct Projects or Purchase Orders (Istisna).

Istisna is financial instrument in which a manufacturer agrees to complete a construction project on a future dare for a fixed, agreed upon price and with product specification that both parties agree to. If the project doesn't fit the contract specification, the buyer has the right to withdraw from it.

The financial instrument provides for payment flexibility between the manufacturer and the buyer. The contract demand that the buyer pay in advance or that the manufacturer receive only a lump sum at the time of delivery. Instead, both parties can set a schedule of payment.

- Istisna instruments are widely used in the construction industry or for project financing and trade financing for example:

  Qatar Islamic bank (QIB) signed an Istisna agreement in late 2010 to finance a major residential complex in the north of Qatar.
- In the Istisna contract, the customer approaches the bank with the desired asset's specifications. Both the customer and then the bank manufacturers the product or the asset for the customer through its agent, such as a manufacturer.(Jamal Al-Deen, 2011, p.159)

3.1.6.1. Opting for Parallel Istisna:

When the bank provides the customer with the Istisna financial instrument, the customer signs the contract with the bank for the specified asset or project.

Then the bank (via it manufacturing agent) manufacturers the asset or project for the customer's specifications. However, in some circumstances the bank doesn't want to produce the item per the customer. In this case, the bank opts to use two mutually independent Istisna contract called parallel Istisna.

3.1.6.1.1. How the System Works?

- The customer who wants the project or asset enters an Istisna contract with the bank per the customer's specifications.
- The bank then enters into a parallel Istisna contract with a manufacturer (which is not the bank agent; it is a separate third party) to meet those some specifications. In theory, when the manufacturer completes the asset or project, it delivers the product to the bank. (In practice, the manufacturer usually delivers the product directly to the customer).
- The bank pays the manufacturer and the customer pays the bank according to the agreed payment schedule. The bank marks up the manufacturer price in the contract with the customer to secure a profit.

This Figure offers an illustration of the parallel Istisna process.

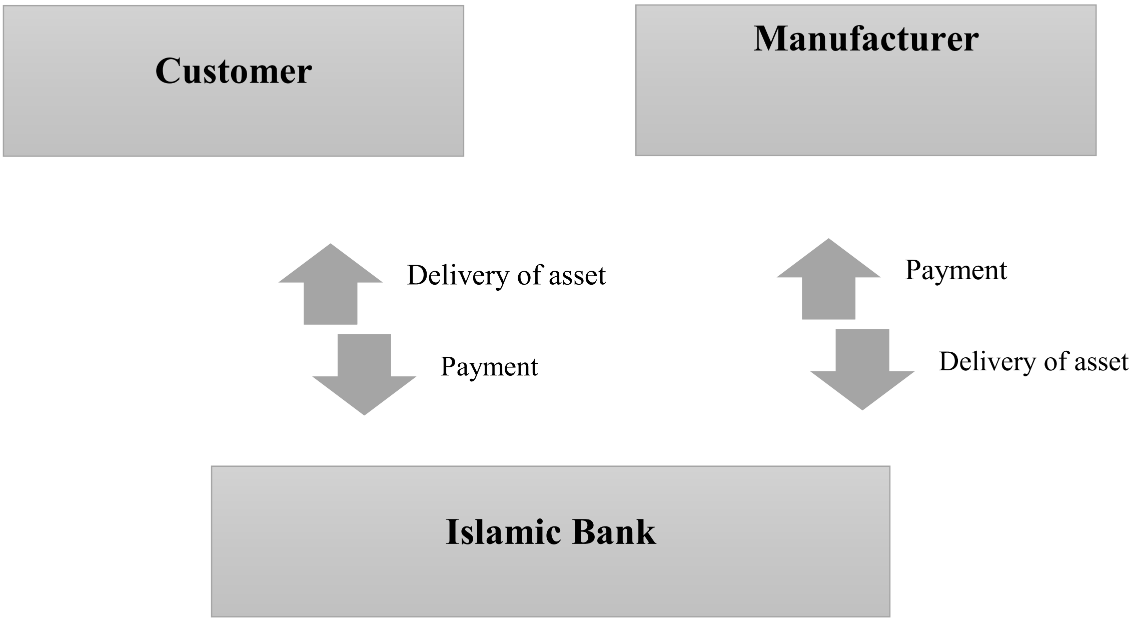

Diagram 3.3. Parallel Istisna process. (Jamal Al-Deen, 2012:.159)

3.1.7. Deferred Payment Sale (Bay Al-Muajil)

The deferred payment sale is a simple transaction in which a product is sold for a deferred payment – either an installment or lump sum. Here are two key conditions:

1. The seller and buyer agree on the price at the time of trade
2. The seller can't change extra if the buyer delays or musses a payment. (Jamal Deen, 2011, p.160).

In practice the bay al-muajil instrument is used in combination with murabaha (cost plus profit; flip the earlier section "making purchases with cost plus profit (murabaha) contract" for more in this product). The bank purchases an asset from a seller and then sells it to the customer at a higher price than the purchase price.

For example, a customer who wants to purchase a house agrees with the seller on a sale price. The customer then seeks an Islamic bank to finance his house purchase, stating the sales price and other facts. The Islamic bank uses an independent valuation to verify the house's value. Then the Islamic bank acquires the house from the seller by changing the ownership and paying the sales price. After the house becomes the Islamic bank property the bank sells the house to the customer at a higher price. Basically, the Islamic bank signs murabaha contract with the customer, and the title is transferred. The customer's payments are secured by the house, and the payment schedule is arranged by both parties. (Jamal Deen, 2011, P.160).

3.1.8. Purchase with Deferred Delivery (Salam)

In the contract, which may also be called bay al-salam, full advance (on the spot) payment is made for goods to be delivered on future date. This instrument is a made of financing future economic activity or a product that is going to be produced in the future. The seller promise to supply the specific products to the buyer on the specific future date; the buyer provides the full funds in advance this upfront payment is the key difference between salam and conventional forward contract. (Jamal Deen, 2011, psx.161).

1. Full payment must be made in advance
2. The product must physically exist
3. The seller must have ownership of the product
4. The product is in the seller's possession or at least in his control

Obviously, the first condition creates a problem when you're talking about a product that someone wants created for future delivery. Therefore, Salam is allowed only with strict conditions, such as these:

1) The seller legally possesses the product to be delivered.
2) The contract specifies the date and time of the delivery.
3) The product's quality and quantity can be specified in the contract.

For example, specifying of where purchase of precious stones is difficult because every stone is different from others in quality, weight or size.

The prophet Muhammad (pbuh) allowed the Salam contract to help farmers buy necessary raw materials. Because interest is prohibited in Islamic law, traders and farmers didn't have the capital to borrow for their investments.

This permission helps farmers and traders get the necessary capital before their production or trading occurs. Otherwise, they would need to seek out interest – bearing borrowing. (Jamal Deen, 2011, p.161)

3.1.8.1. Salam versus Istisna:

- Purchase with deferred delivery

  (Salam, a trade-based financing instrument) an installment payment, or lump sum payment after delivery and construction project finance

  (Istisna, an asset based product) seem to be quite similar, but they have some key difference.
- The full price of a Salam contract is paid in advance, but the Istisna can be scheduled as a payment in advance
- The product delivery date needs to be specified for Salam contract but not for an Istisna Contract.

  (However, a minimum allowed time frame should be included in the Istisna contract).

3.1.9. Other Instrument using in Islamic Bank:

1. Sukuk (Islamic Bounds)
2. Qrad Hasan

1- Islamic Bounds (Sukuk)

Sukuk is the plural from the Arabic word sakk, which means “certificate” or “written document”.

The Islamic Financial Services Board (IFSB) defines Sukuk:

Sukuk are certificates with each sakk representing a proportional undivided ownership right in tangible assets, of pool of predominantly tangible assets, or business venture.

These assets may be in a specific project or investment activity in accordance with sharia rules and principles.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines Sukuk as “certificate of equal value representing undivided shares in ownership of tangible (material) assets, usufruct and services”. Usufruct is the right to earn profit from property owned by another person or from property that has common ownership. Common or collective ownership refers to situation in which many people own on asset, such as lend.

According to Brain kettesl defining Sukuk “the term Sukuk is the Arabic plural of sakk which means a legal instrument, deed, cheque”. Sukuk are financial certificates but can be seen as the Islamic equivalent of a bond. However, fixed income, interest-bearing bounds are not permissible in Islam, hence Sukuk are securities that comply with sharia law and its investment principles.

These principles prohibit the charging or paying of interest. Financial assets that comply with sharia law can be classified in accordance with their tradability and non-tradability in the secondary markets.

FOURTH CHAPTER

RELATION OFISLAMIC BANK WITH CENTRAL BANK

4. INTRODUCTION:

The nature of relationship between Islamic banks and central banks differs from one country to another; it depends on the legal framework which regulates the status of Islamic bank within this countries. Some states have issued special legislation for conventional banking system.

Other states have had the initiative to develop and enforce legislations which would allow establishing Islamic banks in accordance with specific laws and regulations.

Yet there are three aspects of the central bank's relationship with Islamic banks:

1-that are lender of last resort

2-a clearing house and,

3-the central bank can manipulate the supply of money to the commercial banks and hence to the public, it can lend directly to banks to provide liquidity support directly to a bank that cannot obtain finance from other sources.

And more generally it oversees the financial sector in order to prevent crises, protect depositors, prevent wide-spread panic withdrawal, and thus to prevent the damage to economy that maybe cause by the collapse of banks.

While the central bank provides finance to conventional banks or by rediscounting commercial bill, which are prohibited in sahari'ah, it provides liquidity for Islamic banks on the basis of form of mudarabah or musharakah capital, the central bank would share in the profits from the Islamic bank's investment of the money over the period for which the fund are advanced .As clearing house, the central bank provides Islamic banks with facilities for the settlement of cheques and other payments and services around documentary letters of credit and guarantee in return for a commission. The Islamic bank using the clearing system opens a current account with the central bank and limited short-term temporary over draft facilities exempted of interest are occasionally allowed to cover any temporary shortfalls for settlement purposes.

The central bank may allow limited short term temporary facilities free of interest in the case of Islamic banks on the basis that these banks would place compensatory funds of the same amount for an equivalent duration, interest free with the central bank, or the basis of sharing in their profits for the period of the short fall. And as supervisor in regard to monetary policy, the central bank influence credit availability and inflation through money to provide a stable economic growth.

It should design patterns and forms of regular data required from Islamic banks to be developed and approved by central bank and Islamic bank representatives in order to comply with the nature of Islamic bank operations. Some central banks have set a lower level for the liquidity ratios within Islamic banks in comparison with their counter parts in other banks, taking into account the specific nature of their dealing.

However, there are some areas where different controls need to be done between Islamic and conventional banks depending whether they involve interest or not; these controls include statutory cash reserve requirements, liquidity ratios, deposit insurance schemes, credit ceilings, distribution of Islamic banks, profit, inspection of Islamic banks, profit equalization fund and monetary assets.

In fact, control of Islamic banks should take account of their specific characteristics; the statute of an Islamic bank must be approved by the central bank before the latter gives the bank permission to operate. Thus, control of the activities of an Islamic bank and examination of its processes should be conducted in accordance with its statute. Central bank should have a distinctive set of guidelines for the inspection of Islamic banks as well as regulations to safe guard Islamic investors' interests.

The central bank may also evaluate the investment programs of Islamic banks. For example, in cases where central banks pay interest on cash reserves, the ratio of reserves required from Islamic banks could be reduced on the grounds that they are not demanding any interest. Also a special consideration should be applied by central banks when applying credit ceilings to Islamic banks. Also, the minimum interest rates prescribed to commercial banks to pay on savings and time deposits should be replaced in the case Islamic banks by a weightage system to be given to these deposits for the purpose of profit distribution by the banks. (www.financialislamic.com).

4.1. The conditions in Islamic bank regulation and controls of Central bank

Central banks subject islamic banks to the same controls, conditions and regulation that they apply to the interest based banks. However, there are certain factors, which require that Islamic banks should be treated on a different footing.

Some of these factors are the following:

1. Islamic banks like all other commercial banks are required to keep some of their deposits with central banks.

   Central banks usually pay interest on those deposits which Islamic bank cannot accept because of the most important characteristic of Islamic banks from conventional.

   Commercial bank, that Islamic bank doesn't deal with the rate buying or selling because dealing with the interest forbidden. An alternative is needed to ensure that Islamic banks get a fair return on their deposits with the central bank.
2. Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most of Islamic banks function under the supervision of central bank, they cannot legitimately benefit from such a facility because such funds are usually provided on the basis of interest. His understandable that such assistance cannot be free for cost. However, there is a need to devise and implement on interest free formwork for such assistance.
3. Legal reserves imposed on deposits with conventional banks are meant to meet possible withdrawals, whose rates vary between demand, saving and time deposits. This may apply to the same extent only in case of Islamic banks' demand deposits.

   However, the mudarabah a deposits are like bank equity.

   Therefore, Islamic banks should not be required to maintain reserves against them just as equity capital is not subject to those reserves.

4. In countries where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of interested based nature of the securities bought and sold. Thus, Islamic banks are constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of Islamic banks.
5. Lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for rather in appropriate polices of the central banks towards Islamic banks. This is particularly true of musharakah and mudarabah. In debt financing, granting a loon by a bank is a onetime activity, no matter what is the size of the loons. Nut musharakah and mudarabah are ongoing activities and participation of an Islamic bank in these activities countries as long as the project financed is in operation. This may have important implications for reporting as well as control and regulation of Islamic banks by the central banks.
6. Central bank regulators are sometimes unclear about the exact role of Shariah boards. It is sometimes felt that these boards may interfere in the banks' decisions with regard to monetary policy tools such as reserve requirements, open market operation, etc. it would be desirable to determine the exact role of the Shariah boards and take the central bankers into confidence. (Iqbal, Ahmad, Khan, p. 37, 1998).

4.2. Tools and methods of traditional control and particularity of the Islamic banking work.

The need for the regulation of relation between the central bank and the Islamic bank is a mutual need, the Islamic bank needs the assistance of the central bank if it lacks liquidity, and it needs the trust of the public which can only be secured when everybody knows that the central bank will assist the Islamic bank during its crises through the control and its subjection to different control tools, moreover the central bank cannot deny the existence of the Islamic bank since it is keen to control all banks and financial institutions operating in the banking sector under its supervision (Mira, 2011). Hereunder are the control tools applied by the central bank on the traditional banks, and the extent of their appropriateness to be applied on the Islamic banks, and the available alternatives in case of their non-appropriateness.

4.2.1. Discount rate and particularity of the Islamic banks.

The discount rate, or the so called rediscount rate, is like the interest rate earned by the central bank from the commercial banks against its rediscount of the promissory notes and bills submitted to it, the central bank obtains a discount rate when presenting guaranteed loans to the commercial banks (Hassan,1990). The discount rate provides the possibility of real opportunities to the traditional banks to obtain loans from the central bank, in particular when these banks face unexpected loss in reserves or an increase in a sudden market of credit or the inability to obtain the required liquidity in the money market (Eshamri, 1999).

On the other hand, the central bank controls the interest rate, by increase or decrease, according to different economic circumstances in order to effect the available credit volume, so if there are signs of inflation, the central bank raises the interest rate to increase the cost of loans on the commercial banks and its clients, and hence limit the credit volume and reduces the available payments means in economy, however if here are signs of deflation the central bank will reduce the interest rate to encourage the loans, and hence increasing the payment means (Alhurani, 1999). In view of the discount rate policy we find that Islamic banks cannot benefit from it, since this policy contradicts with its principle of work based on non-dealing with usury interests.

However the central bank can adopt, instead of the discount rate policy, a formula which can be appropriate with the rules of work of the Islamic bank such as a special contractual agreement between the central bank and the Islamic bank setting out the non-dealing with interest on the discount, i.e. the central bank earns an interest against the discount on negotiable instruments, and the Islamic bank deposits at the central bank an amount even if small but without interest. And if the central bank receives these instruments he makes them as a guarantee for loans granted to the Islamic bank without counting the interest upon their transfer to liquidity, or is returned by the Islamic bank in the manner of venture or participation or murabaha after transferring it to money, therefore the central bank shall rely on the system of participation in profits and losses instead of the system of interest, so that it can support the activity of Islamic banks and assist them in attaining their goals(Malak, 2000).

The central bank can fix the minimum and maximum limits of the interest rate through fixing the minimum and maximum limit of profits and losses, and therefore it subjects to all forms of loans, deposits and drafts accorded to the Islamic banks to the mechanism of investment work which in turns is subject to profit or loss, and this can determine the form of participation of the central bank in the framework of the Sharia formula in a way similar to the effect caused by the change in the interest rate, the central bank adopts the policy of changing the rate of participation in profits for the accorded financing, in line with its objectives aiming to control the credit and regulate the demand on the bank financing in general. When the central bank aims to extend the cover of credit, its participation will be limited to achieving a lower profit margin, and conversely in increases the profit margin, and accordingly the net margin of profit achieved by the Islamic bank is affected and hence contributing in controlling its financing and the domain of its participation in making the desired credit.

4.2.2. Operations of the open market and particularity of Islamic banks.

These operations are summarized in that the central bank sells and buys negotiable instruments in the money market, in order to minimize the credit volume provided by the commercial banks by competing with them, and also to make a pressure on the liquidity of individuals if they sell negotiable instruments, this policy includes the dealing in foreign currencies and gold. In case of deflation, the central bank buys negotiable instruments in order to increase the liquidity in economy, and in case of inflation it sells the negotiable instruments in order to reduce liquidity (Alhindi, 1989). The dealing with negotiable instruments, such as government bonds, is deemed in contradiction with the rules of Islamic Sharia since these bonds represent a form of a loan contract, and they bear a fixed interests from their nominal value, and hence they are transformed to a form of usury loans which in their nature are contradicting with the nature of Islamic bank work.

Amongst the alternatives presented in the treatment of the difference of dealing with instruments, the central bank issues different negotiable instruments based on the principle of participation in profits and losses, which are in the form of coupons bearing variable rates of profits instead of instruments bearing fixed usury revenue, and by this mechanism the central bank can achieve its monetary goals and controls the volume of monetary offer as per these objectives, in case of its policy aiming to reduce the monetary offer, the central bank shall fix rates of profits less than the selling of coupons, and its participation will be lesser and with greater ability to absorb the savings and hence reduce the monetary offer, and in case of purchase it can fix the rate of profit higher through greater participation and hence extending and increasing the volume of monetary offer and achieving larger domains of credits(Aljamal,2003).

4.2.3. Legal cash reserve and the particularity of Islamic banks.

The central banks' policy in countries with different affiliate banks are bound with the necessity to keep with them certain percentage from the total value of deposits at each bank as a cash balance in a special account kept at the central bank, this percentage changes from a country to another, and generally it ranges from (10% to 25%) from the total value of different deposits at each bank, by the use of the reserve the central bank aims to control the volume of credits which can be given by these banks, and therefore effecting the ability of money crearion (Yasser Alhurani, p.125).

This tool is not in conformity with the nature of funds at the Islamic banks since they are different from traditional banks, since the funds were provided to the Islamic banks for the purposes of investment on the basis of venture for example, and this means the sharing of responsibility between the bank and the funds owner according to the effective outcomes of the investment, and hence there is no obligation on the Islamic bank to warrant the reimbursement of these funds in full to their owners except what concerns trespass and negligence, and this is different from the deposits in traditional banks which are deemed debts in the liability of the bank.

Furthermore, the ability of the Islamic banks to create cash and increase the cash offer is very limited if compared with the state of financing with loans at the traditional banks, since the employment of funds at the Islamic banks is found in real investments (Irshid, 2007). Accordingly, it appears that the policy of legal cash reserve contradicts with the sound employment of funds in full, and its affects negatively the investment power, and the revenue distributed on the owners of investment accounts, since they hinder a part from these accounts without investment, however despite this tool is not in conformity with the philosophy and nature of the Islamic banking work however it favors the traditional banks.

Therefore, it is necessary to adapt the obligatory reserve to be in harmony with the particularities of the Islamic banking work, and the main concepts in this field are as follows:

A. the central bank shall exempt the investment deposits at the Islamic bank from the accounts of reserve restrictions since these deposits are provided by depositors to the Islamic bank on the basis of venture according to the effective outcomes of investment, such as profits and losses, and hence there is no obligation on the Islamic bank regarding the necessity to reimburse them in full since they are not guaranteed at the banks as is the case for the term deposits at the traditional banks, moreover the policy of legal reserve leads to the hindering of a part from the resources of Islamic bank regardless of the desire of the depositors and contradicts with the sound employment of funds in full, and this affects negatively the revenue distributed on the holders of the investment accounts (Dwaba ,2005,p.17).

B. the non-application of the penalty interest rate on the Islamic bank in case of non-fulfilling the minimum limit of the legal reserve requirements, and its replacement by a system of fines related with the volume of default, in harmony with the reality of Islamic banking work which is safe from usury (Dwaba, 2006,p.17). The central banks' policy in countries with different affiliate banks are bound with the necessity to keep with them certain percentage from the total value of deposits at each bank as a cash balance in a special account kept at the central bank, this percentage changes from a country to another, and generally it ranges from (10% to 25%) from the total value of different deposits at each bank, by the use of the reserve the central bank aims to control the volume of credits which can be given by these banks, and therefore effecting the ability of money crearion (Yasser Alhurani, p.125).

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4.2.4. Cash liquidity and the particularity of the Islamic banks.

Among the procedures carried out by the central banks in order to regulate the liquidity and protect the funds of depositors as a guarantee for their reimbursement, they impose a rate of liquidity determined by the central banks from the total balances of the depositors at a commercial bank, the bank will keep the balances corresponding to this percentage in the form of liquidity in its treasuries or at the central bank, provided that these elements are kept from assets with high liquidity to facilitate their transfer to cash in case of increase in the movement of drafts by depositors above he expected percentage, some of these elements are debentures and promissory notes yielding revenue to the traditional banks, on the other hand we notice that Islamic banks do not deal with such manner, and hence in order to keep the prescribed liquidity rate these banks shall keep larger quantities of liquidity which do not yield any revenue(Yasser Alhurani, "Evaluation of the functional relation disruption sides between the central bank and the Islamic bank", previous reference, p.113). The rate of liquidity prescribed by the central banks are usually around (20% to 25%) from the total deposits (Ahmed, 1993).

The implementation of the cash liquidity policy on the Islamic banks obliges them to keep large rate from the investment clients' deposits in the form of liquid assets, and hence reducing the investment power of such deposits, and minimizing their profitability. Therefore treating the Islamic banks and traditional banks equally regarding the imposition of this rate makes the Islamic banks in a non- competitive and unfair position preventing them from investing inoperative funds, since the doctrine rule relied upon by the Islamic banks is the rule "if you benefit from a deal you have to pay for its expenses" and this in turn makes the Islamic banks unbound to warrant the funds of investors and they are partners in profits and losses.

4.2.5. Credits caps and the particularity of the Islamic banks.

The credits caps consist in regulatory procedures by which the central banks fix the maximum limit of the loans portfolio which may not be exceeded by the commercial banks, by a direct administrative manner according to rates fixed during the year, this is done in order to limit the expansion in total financing or keeping it at a secured level for cash expansion and the required financing, and also the distribution of loans towards sectors deemed more vital for development or requiring large financial resources, i.e. warranting a purposive distribution of the banks' investments and allocating funds in investments fields which achieve economic welfare through a plan drawn up by the state in determining the priorities and objectives of the society(Dwaba , p.15).

Regarding the extent of appropriateness of this control criterion for implementation on the Islamic banks, it is preferred not to use it since its implementation can lead to negative impacts harming the depositors and shareholders, knowing that the nature of works of the Islamic banks differ from the methods of credits granting at the commercial banks, the formulae of Islamic financing such as Murabaha and Istisnaa and Muzaraa are based mainly on the use of commodities, i.e. financing operations for the production of commodities, directly or indirectly, in other words, the cash flows resulting from these formulae are related with the commodities flows more than those resulting from credits granting process at the traditional banks, and hence the expansion in Islamic financing has relatively low impact as compared with the impacts of traditional financing related with inflation (Almabruk ,2007).

4.2.6. Prohibition to deal with movable and immovable assets and the particularity of the Islamic banks.

The central banks prohibit from the commercial banks to own immovable or movable assets except to the extent needed by the banks in terms of real estates and movable assets allocated to the management of the bank businesses. This restriction is in conformity with the nature of the traditional banks which rely on the third parties' funds as a commodity for trading, and this matter contradicts with the features which distinguish the Islamic banks from the traditional banks (Sowan, p.238).

The nature of investment in Islamic financing is based on the fact that money is a means of investment in productive, service and industrial operations, and therefore the Islamic system is characterized by the ownership of assets, whether immovable or movable, given that it is participant and not a financial mediator like its traditional counterparts.

4. 2.7. Policy of the last lender and the particularity of the Islamic banks.

Central bank is deemed the last recourse for the commercial banks, and if they need liquidity they recourse to it and take what they need against interest, however for the Islamic bank we cannot support its positions in the field of liquidity and credit by benefiting from granted loans due to their relation with usury discount rate (Irshid, p.318). To avoid such difference in the relation of the central bank with the Islamic bank there are many methods, mainly (Shebir, 1999).

A. the contribution of the Islamic banks and financial institutions by a defined rate of their deposits at the central bank, and this contribution will form one bank deposit accorded by the central bank to any Islamic bank facing real risks and problems.

B. the central bank shall adopt the method of participation in profits and losses, and in the implementation of this mechanism it shall adopt the application of preferential participation rate for the sectors with priority instead of preferential discount rates.

C. make a world or central Islamic bank playing the role of the last lender according to the rules of the Islamic Sharia through the membership of the Islamic banks wherever they exist, and regardless of the privileges of the one region.

FIFTH CHAPTER

THE RELATION OF UNITED ARAB EMIRATES WITH EMIRATES ISLAMIC BANK.

5.1. U.A.E.CENTRAL BANK:

After the creation of the United Arab Emirates in 1971, a 'Currency Board' was established in May 1973, as per Union Law No. (2) Of 1973. The Currency Board was mandated to issue the national currency that replaced the Bahraini Dinar and the Qatari and Dubai Riyal currencies in use at the time.

The UAE Dirham went into circulation in May 1973. Within weeks, other currencies in use were replaced by the UAE Dirham, at the rate of one UAE Dirham to a Qatari/Dubai Riyal and ten UAE Dirhams to a Bahraini Dinar.

The Currency Board's functions were limited to issuing the UAE Dirham and ensuring its full coverage in gold and foreign currencies. The value of the UAE Dirham in gold stood at 0.186621 grams and it was pegged to the US Dollar at a rate of 3.94737 to a dollar, within a narrow margin.

On 10 December 1980, "Union Law No. (10) Of 1980 Concerning The Central Bank , The Monetary System And Organization of Banking" was issued, creating the Central Bank of the UAE and providing the Central Bank with authority over the organization of the monetary and banking systems in the UAE. This includes the organization of monetary, credit and banking policy in the UAE and the supervision of its implementation. The Central Bank's mandate includes : (1) issuing of the currency, as per the provisions of the said law; (2) stability of the currency as well as its free convertibility into foreign currencies; (3) credit policy to achieve balanced growth of the national economy; (4) organization and development of banking as well as monitoring of the efficiency of the banking system; (5) function as the Bank of the Government; (6) offering monetary and financial advice to the Government; (7) maintaining government reserves in gold and other currencies; (8) acting as 'bank of banks’ operating in the country; and (9) acting as the financial agent of Government at the International Monetary Fund and the World Bank and other international and regional financial institutions. The Central Bank is also authorized to handle all State transactions with such parties.

Since the creation of the Central Bank, the banking sector evolved in response to the needs of the expanding economy. At the end of the year 1980, M0 reached AED 2.4 billion while M1 stood at AED 7.4 billion, M2 at AED 23.6 billion and M3 at AED 33.0 billion. By the end of 1990, M0 more than doubled to reach AED 4.9 billion, while M1 reached AED 10.8 billion, M2 reached AED 58.1 billion and M3 reached AED 73.2 billion. At the end of 2000, M0 stood at AED 12.2 billion while M1 stood at AED 34.1 billion, M2 at AED 141.5 billion, and M3 at AED 184.0 billion. At the end of 2010, M0 reached AED 47.8 billion, M1 at AED 233.0 billion, M2 at AED 786.4 billion, and M3 reached AED 985.2 billion.

Total bank lending increased from AED 21.2 billion at the end of 1980 to reach AED 43.4 billion at the end of 1990, AED 155.2 billion at the end of 2000, and to AED 972.1 billion at the end of 2010.

Foreign assets of all banks operating in the UAE increased from AED 28.5 billion at the end of 1980 to AED 62.9 billion at the end of 1990, to AED 91.5 billion at the end of 2000, and to AED 233.5 billion at the end of 2010.

Total asset of banks operating in the UAE reached AED 30.9 billion at the end of 1980, AED 129.7 billion at the end of 1990, AED 277.1 billion at the end of 2000, and AED 1609.3 billion at the end of 2010.

As regards the Central Bank, its total assets stood at AED 9.80 billion at the end of 1980, AED 17.3 billion at the end of 1990, AED 50.1 billion at the end of 2000, and AED 228.9 billion at the end of 2010.

5.1.1. Objectives:

The Central Bank formally commenced its functions on 11 December 1980 in pursuance of the provision of Union Law No. (10) Of 1980, which superseded Union Law (2) of 1973, establishing the former Currency Board in the United Arab Emirates. In defining the Central Bank's objectives, Article 5 of Union Law No. (10) Of 1980 states that the Central Bank:

Shall direct monetary, credit and banking policy and supervise over its implementation in accordance with the State's general policy and in such ways as to help support the national economy and stability of the currency.

For the attainment of these objectives, the said law empowers the Central Bank to:

- Exercise the privilege of currency issue;
- Endeavor to support the currency, maintain its stability internally and externally and ensure its free convertibility into foreign currencies;
- Direct credit policy in such ways as to help achieve balanced growth of the national economy;
- Organize and promote banking and supervise over the effectiveness of the banking system;
- Undertake the function of the bank of the government within the limits prescribed in the law;
- Advise the government on financial and monetary issues;
- Maintain the government's reserves of gold and foreign currencies.
- Act as the bank for banks operating in the country; and
- Act as the State's financial agent at the International Monetary Fund, the International Bank for Reconstruction and Development, and other International and Arab Funds and Institutions and carry out dealings of the State with such concerns.

5.1.2. Qualified Monetary Instruments:

As per Union Law No (10) of 1980, the Central Bank of the UAE (CBUAE) can use a number of instruments to attain its monetary objectives. The fixed peg of the Dirham to the US dollar, however, means that local interest rates have to be aligned to those of the dollar across the maturity curve. As a result, the effectiveness of monetary policy instruments at the Central Bank's disposal has been reduced.

The CBUAE currently offers the following to commercial banks for managing their liquidity:

(1) The minimum reserve requirement

(2) Dollar/Dirham swaps for Dirham liquidity

(3) Advances & overdraft facility for banks

(4) Prudential regulation and

(5) CBUAE issuance of Certificates of Deposits and Repo facilities on Certificates of Deposit (CDs) held

(6) Liquidity Support Facility

1. Minimum Reserve Requirement:

The minimum reserve requirement ratio relates to the reserves banks are required to have at the Central Bank without interest. Monetary policy could be managed by controlling the level of these reserves, which in turn will impact the amount banks provide in loans to the economy.

Currently, the required reserves ratio is 14% on current, savings and call accounts, and 1% only on time deposits. In addition, banks are required to keep at the Central Bank 30% of their Dirham deposits abroad with non-resident banks (including their Head Office and branches in the case of foreign banks). The ratios on local customer deposits apply uniformly to Dirham and other foreign currencies.

2. Dollar/Dirham swaps for Dirham liquidity:

Dollar/Dirham swaps are a mode of injecting Dirham liquidity in case a bank needs access to Dirham. Swap arrangements involve a simultaneous sale and forward purchase of Dollars against the purchase/forward sale of equivalent Dirham amount for a fixed term at specified forward rates. Swap terms range from one week, one month, 3 months, 6 months, 9 months to 12 months. The swap facility was set up at the request of local banks to overcome temporary shortages of Dirham liquidity.

The facility is available to all banks operating in the UAE under the jurisdiction of the Central Bank of the UAE.

3. Advances and overdraft facility for banks:

The Central Bank can provide banks with loans and advances for up to 7 days without collateral, and for up to 6 months against collateral. The Central Bank provides an overdraft facility to commercial banks that allows them to utilize their required reserves free of charge for up to seven days.

4. Prudential Regulation:

A. Capital adequacy ratio

UAE banks are well capitalized with respect to Basel I requirement. The capital adequacy ratio in the UAE, should not be less than 10% according to CBUAE's requirement, compared to 8% Basel requirement, which was increased to 11% starting September 2009 and 12% starting June 2010.

B. Loan-to-Stable-Resources Ratio

Banks are required to maintain a loans & advances to stable resources ratio equal to one. The numerator comprises loans and advances (including interbank placements with a remaining maturity of more than three months), while the denominator comprises free capital and reserves, interbank deposits received with a remaining maturity of more than six months and 85 percent of customer deposits.

C. Personal Loan Limit

Personal loans are defined as loans that are given to individuals for specific purposes, secured by assigning salary and end-of-service benefits and any regular income from a well-defined source. The ceiling for personal loans is currently set at 250 thousand Dirhams. It is prohibited to include private houses of individuals or guarantees from nationals as securities for personal loans. At present, credit card loans are excluded from the personal loan limit.

D. Large Exposure Limits

With a view to curb excessive concentration of credit to a single borrower or a group of related borrowers, the Central Bank issued on July 16, 1994 an update of Circular 19/93 relating to the monitoring of large exposure limits to banks, banking groups, members of a bank's board of directors, and the bank's own employees. Aggregate large exposure limit is currently set at 8 times the capital base of the bank.

5. Certificates of Deposit

Certificates of Deposit (CDs) are issued by the Central Bank, as a tool for liquidity management. The system was essentially demand-driven as banks with excess liquidity can invest their surplus funds in CDs of varying maturities. The CDs program was launched in 1985, amended in 1994 and in 2007.

The New Expanded Central Bank CDs Issuance System became effective 28 November, 2007. It is an auction based issuance for CDs denominated in UAE Dirhams, US dollars and Euros (data on CDs outstanding is published on the Central Bank Balance Sheet and the Central Bank Statistical Bulletin).

CDs of shorter maturities ranging from 1 week to 12 months are issued daily while CDs of longer maturities ranging between 2 years to 5 years are issued on the first Monday of each calendar month.

Under the new issuance system, banks can repo their CDs with the Central Bank of the UAE or between themselves to access liquidity. The repo term offered by the Central Bank is upto 3 months as long as the CD being used as collateral has a balance life beyond the repo term. Banks can also seek Dollar term funding by using their holdings of CDs as collateral.

Banks can redeem CDs with the Central Bank at any point during the life of the CD as long as the CD is free from any encumbrance.

6. Liquidity Support Facility:

This facility was set up in September 2008, when banks were facing a shortfall in liquidity due to the global financial crisis. Under this facility, a bank can submit its portfolio of securities to the Central Bank of the UAE for evaluation. The Central Bank will accept those securities as eligible which satisfy its guidelines and assign a line to the bank based on the value of the eligible securities after adjusting for haircut applied to each such accepted security. The bank can then access Central Bank funds on a weekly rollover basis for as long as they need the facility.

5.1.3. Organization & Development:

According to the Board of Directors of the Central Bank of the United Arab Emirates (CBUAE) Resolution No. 56/3/93, dated 19/4/93, reorganizing the structure of the institution, CBUAE has now, five branches, seven departments, seven divisions, seven units and the Risk Bureau.

The Central Bank maintains five branches in major cities of the country, in addition to the Head Office located in the capital city Abu Dhabi. Central Bank branches are located in Dubai, Sharjah, Ras Al Khaimah, Fujairah and Al Ain.

These branches facilitate inter-bank dealings as well as banks dealings with the Central Bank. Each branch consists of three main sections, namely, Banking Operations, Accounts and Administrative Affairs.

The CBUAE has 7 Departments. Banking Supervision and Examination, Banking Operations, Research and Statistics, Administrative Affairs, Financial Control, Treasury, and Internal Audit, 7 Divisions (Information Technology, Personnel, Correspondent Banking, Public Relations, General Secretariat and Legal Affairs, UAE SWITCH, and the Governor's Office Division) and 7 Units (the Anti - Money Laundering and Suspicious cases Unit, IT Projects Unit, the Strategy Unit, the legislative Development Unit, the Banking and Monetary Statistics Unit, the Financial Stability Unit, and the Benchmarking Unit), in addition to a Risk Bureau.

The Banking Supervision and Examination Department (BSED) is responsible for the soundness of financial Institutions, including local banks, branches and representative offices of foreign banks, moneychangers, finance companies, as well as brokers in shares and financial instruments, financial investment companies and financial consultancies.

The Department is responsible for setting the standards regulating the sector, monitoring compliance, and it processes applications for licenses.

BSED is also entrusted with the task of international cooperation with other regulatory authorities and supranational institutions, such as the Bank for International Settlements, the Financial Action Task Force, the International Monetary Fund, and the World Bank.

The Banking Operations Department consists of five sections: (1) Currency Notes & Coins Section, (2) Vaults and Strong Room Section, (3) Banking Operations Follow-up Section, (4) Banking Operations Statistics Section, and (5) Check clearing.

Under the supervision of this Department, new banknotes are printed and launched. They feature the most up-to-date security marks and maintain technical specifications of the highest standards. The Department also issue several gold and silver commemorative coins in celebration of various national occasions, it monitors the UAE funds transfers system and the UAESWITCH.

The Research and Statistics Department (RSD) is the main source of monetary and banking statistics. This is regularly disseminated through UAECB publications, namely the Annual Report, the Economic Bulletin and the Statistical Bulletin. RSD is also entrusted with the task of follow up with international institutions, particularly the Arab Monetary Fund (AMF) and the International Monetary Fund (IMF). And it coordinates with other statistics providers in the country (Customs, Ministry of Economy...).

The Administration Affairs Department (AFD) consists of: (1) the Purchasing Section, (2) the Maintenance Section, (3) the Correspondence and Archives Section, (4) the Security and Guards Section, and (5) the Library.

The Financial Control Department's main functions are to monitor, control and report on the financial aspects of the Central Bank. This department consists of three sections: (1) Accounts, (2) Treasury Operations, and (3) Management Information.

The Treasury Department (TD) is responsible for the day-to-day management of the Central Bank's reserves. These reserves are the counterpart of: (1) commercial banks' reserve requirements, (2) currency in circulation, (3) the issuance of Dirham denominated Certificates of Deposit, and (4) capital reserves and permanent deposits from the Federal Government.

TD's investment strategy places considerable emphasis on liquidity and preservation of capital. Thus, only certain government issues (largely, in the G7 markets) and certain other fixed income securities with the highest investment grade ratings are considered.

The Department is divided up into four main sections: (1) Capital Markets, (2) Money Markets and Foreign Exchange, (3) Certificates of Deposit, and (4) Back Office Settlements.

The Internal Audit Department (IAD) is entrusted with the two following tasks:

First: This department shall undertake the following tasks:-

Perform pre-audit procedures on all transactions involving telex or Swift transfers or instructions to debit the accounts of the bank with central and commercial banks.

Continuously ensure the proper functioning of computer security system, particularly with regard to code numbers and security levels, which control access to documents and execution of financial transfers through the computer.

Perform post-audit procedures on expenditures of the Head office and branches and report to the board and the Governor any violations to provisions of the Law or the Bank's rules and regulations, in such respect. Audit the Bank's holdings and stock of currency notes; coins and gold, as well as operations relating to the receipt of currency notes and coins from printing and minting houses, in accordance with the instructions issued in such respect and participate in the annual stock-taking of the Bank's assets.

Second: The department shall, at the end of each month, prepare and submit to the Governor a report, and also at the end of each quarter a more comprehensive report, reviewing its auditing activities during that month and for the year. The reports should also highlight measures taken for the purposes of avoiding shortcomings and mistakes, along with proposals aimed at ensuring proper execution of the Bank's operations and enhancement of its technical and administrative standards.

The Information Technology Division (IT) studies manual systems in the Central Bank and the feasibility of their automation. To this end, IT Division carries out Software evaluation and it develops programs required for automation, in addition to the identification of the equipment needed, in this respect.

Other tasks of IT Division include:

Develop and update structural designs for data-files or database systems, and explain the manner in which database files may be utilized.

Provide training and relevant technical assistance to users of computer systems in the Central Bank.

Provide council and technical advice to the Central Bank's management on automation and systems.

Perform routine data processing work.

Perform procedures relating to hardware installation, determine specifications, maintain and monitor functioning thereof.

Operate systems and application software.

Effectively manage telecommunication network operations within the security, and protect measures prescribed for such operations.

Perform hardware evaluation procedures and operation systems.

Organize and follow-up access to the Computer Center.

Manage the various aspects of system security, including code numbers assigned to systems' operators.

Receive and register programs provided by suppliers and maintain original copies thereof.

Maintain in a safe place all documents relating to computer systems along with tapes, diskettes, books and pamphlets.

Ensure that the process of data entry and retrieve is conducted in accordance with established procedures.

Enter accounting data to the computer and prepare the relevant monthly, quarterly and annual reports.

The Personnel Division comprises three sections: (1) Staff Salaries & Expenditure Section, (2) Contractual and Individual Affairs Section, and (3) Development and Training Section.

I - Staff Salaries and Expenditure Section

Its main tasks are:

Carry out procedures relating to payment of staff salaries, increments, allowances, remuneration, and disbursement of medical expenses, in addition to providing insurance coverage for Staff work related injuries and payment of Staff loans and accommodation leases

Prepare the estimated annual budget of Staff expenses, and

Organize documents, settlement memorandums and payment orders, execute financial settlements relating to the section's works and maintain records, statements, and data which might be required by the section.

II - Contractual and Individual Affairs Section

Its main tasks are:

Implement the provisions of the Staff Regulations and any rules, instructions or resolutions issued in accordance therewith, and ensure proper implementation of resolutions issued by the Board, the Governor and the Executive Committee.

Determine the recruitment needs, prepare appropriate advertising and carry out recruitment procedures, and Execute and/or follow up administrative and other routine procedures relating to Staff attendance, appointments, confirmation of appointments, increments, promotions, and transfer along with procedures relating to provision of insurance and medical care to employees and their families, and medical check-ups for new recruits.

III- Development and Training Section

This section undertakes to:

Propose training programs for new and existing staff with a view to enhance their capabilities and efficiency.

Follow up employees' development and develop special qualification programs for promising employees with potential caliber to be promoted to more significant posts in the future, and

Follow up all matters relating to employees' study leaves and training courses, in accordance with the Bank's established rules.

A new Correspondence Banking Division has been established, consisting of three sections, namely, Correspondents, Financial Analysis and Test Keys. The Division aims to follow-up international credit risks to reduce risky placements with such institutions. The Division also undertakes follow-up and documentation of Central Bank dealings with international banks and organizations.

The Public Relations Division has become an independent unit, entrusted with contacts with the media for the publication of Press Releases, Circulars and Directives issued by the Central Bank. The Division also undertakes supervision over social and sports activities.

The General Secretariat and Legal Affairs Division undertakes secretarial works for the Board of Directors and the Executive Committee and provides legal counsel to the Board, the Governor and other Departments of the Central Bank. This is to ensure compatibility of the Central Bank's rules, procedures and circulars with the constitution and established laws in the country.

The UAE SWITCH Division was created when the Central Bank proceeded with the execution of the Electronic SWITCH project, which aims to connect the automated teller machines (ATMs) of banks operating in the country through a unified network managed and supervised by the CBUAE. The electronic SWITCH provides services such as cash withdrawals, balance enquiry and point of sale services (POS) to bank customers.

The UAE Interbank SWITCH, which became operational since 1996, facilitated the use of ATMs. As a result, at end 2006, a total of 1,603 ATMs are connected to UAE SWITCH, and 7,700 ATMs are connected to GCC SWITCHES.

Governor's Office Division

This division undertakes to:

Prepare responses to correspondence in both Arabic and English languages received from local entities and entities outside the UAE,

Maintain files relating to correspondence with Arab and foreign Central Banks and follow-up of current issues with such banks,

Organize Governor's interviews, meetings and lectures/articles in addition to responses to media questions, and

Maintain the Governor's files of Director's meetings, meetings of GCC Governors, Arab Governors and the International Monetary Fund (IMF), in addition to subjects relating to these institutions and its current issues.

1- The Anti-Money Laundering and Suspicious Cases Unit (AMLSCU) was created to enhance the Central Bank's actions in support of international efforts to combat money-laundering and the financing of terrorism, and in fulfillment of United Nations Security Council Resolution No. 1373 of 2001, and IMF Executive Board Decision No. 144-(52/51). To this end, swift measures were taken by UAECB to search for and freeze accounts that belong to individuals and/or organizations identified as having links to terrorism. Moreover, the Anti-Money Laundering and Suspicious Cases Unit (UAEFIU) was set up at the Central Bank and strengthened by additional human and financial resources, and it became a member of the Egmont Group in June 2002.

2- The IT Projects Unit (ITPU) was created in 2002. The unit is responsible for delivery of all major IT Projects undertaken in implementation the strategy of the Central Bank. Projects are initiated by the IT Committee, which is made up of senior management and chaired by His Excellency the Governor.

Solutions are either developed in-house or are sourced from third party suppliers. The ITPU is continually evaluating emerging technologies, in its quest to ensure that the Central Bank delivers efficient and cost effective solutions to the financial sector in the UAE.

Major projects undertaken include:

Payments systems

RTGS

Image based cheque clearing. The clearing system currently in use has been developed into an automated system, which ensures more accurate inter-bank settlements.

Anti-Money laundering reporting systems

Risk Bureau systems

Banking Supervision reporting systems

Office automation solutions

As regards funds transfer, an Interbank Funds Transfer System (IFTS) replaced the Telex transfer system in August 2001. It is real time gross settlement for funds transfer between banks, cash withdrawal/deposit pre-authorization, account status monitoring, account reconciliation facilities... The system, which was developed in-house to maintain full control over the facilities, reduced systemic risk, eliminated the need for Central Bank intervention in the inter-bank payments, and streamlined cash-handling services. As a result, transfers through IFTS increased substantially.

Based on requirements of the Federal Government's Strategic Plan, the following units were created in 2008: the Strategy Unit, the Legislative Development Unit, the Banking and Monetary Statistics Unit, the Financial Stability Unit, and the Benchmarking Unit.

2- The Strategy Unit:

Its main function is to follow-up good implementation of Central Bank's Strategy and its operational plans. Its main tasks are:

- Coordinate with Central Bank's Departments, Branches, Divisions and Units concerning Central Bank's Strategy and its operational plans, including but not limited to implementation of initiatives and operations and confirm their effectiveness.

- Follow-up performance of Central Bank's Departments, Branches, Divisions and Units concerning implementation of Central Bank's Strategy and its operational plans, and submit brief periodic reports to the Governor in this regard.

- Propose restructuring of sections within Central Bank's Departments, Branches, Divisions and Units, in line with the strategic objectives.

- Coordinate with the Prime Minister's Office, ministries, federal and local authorities, concerning Central Bank's Strategy and its operational plans.

4- The Legislative Development Unit:

This Unit undertakes the review of economic, financial and banking laws and propose updating thereof. Its tasks are specified as follows:

1- To review banking and financial laws and related regulations and propose updating them.

2- To participate within Central Bank's assigned Team to meet with technical committees at Ministries and Government Institutions, for the purpose of reviewing economic laws and propose amendments thereof.

3- To coordinate, via the Central bank above team, with Ministries, Federal and Local Authorities regarding reviewing of laws.

4- To review proposed agreements and memorandums of understanding, to which the Central bank is a party, and provide legal opinion on them.

5- The Banking and Monetary Statistics Unit:

It main task is to prepare all needed banking and monetary statistics. More particularly, it has to:

1- Receive the dully filled-in BRFs by banks and other financial institutions supervised by the Central bank electronically.

2- Receive statistical tables relating to issued currency and cheques from the Banking Operations Department and receive Treasury Department's data and UAE Switch data, all electronically for classification and for preparing related reports.

3- Receive liquidity information from banks, finance/Investment companies on Thursday of every week and prepare a liquidity report.

4- Receive information on Credit portfolios and deposits monthly from banks, finance / Investment companies and prepare a report on growth of credit versus deposits and mark against names of banks exceeding limits of ratios.

6- The Financial Stability Unit:

Financial Stability is referred to as the smooth functioning of the components within a county's financial system.

Established late 2008, the FSU focus is the entire UAE financial system, not individual institutions. It aims at improving the understanding of System Financial Risk to the UAE through the review and analysis of banking and monetary statistics; it makes recommendations for addressing systemic risk.

7- The Benchmarking Unit:

Its main function is to prepare benchmarks relating to low- risk debt instruments and the yield curve.

The Risk Bureau (RB) was created in 1982. It provides information to lending institutions operating in the UAE about applicants, through the following systems:

1- Risk Bureau's Commercial Credit System

In an attempt to provide a better business environment for banks, finance companies and investment companies operating in the country, and in order to assist these institutions in making sound decisions with regard to extending credit facilities to their customers, the Central Bank of UAE is pleased to introduce a new system within the Risk Bureau. The new system will seek to keep up with the great progress in the area of information technology and utilize new computer facilities in providing a more comprehensive view that would facilitate proper assessment of borrower's positions by banks and other financial institutions operating in the country.

2. The System:

According to the new system, which is called the " RB Commercial Credit System", banks, finance companies and investment companies shall report data on their borrower customers (on line) through their own computer systems, which would be linked by a telephone line with the Risk Bureau's database. The Bureau shall in turn process these data in order to provide consolidated reports on the credit facilities extended to one single borrower, the group he is related to, along with the borrowers related to the owner, or one of the partners.

The Beneficiaries:

All banks, finance companies and investment companies operating in the UAE.

Types of Borrowers Covered by the System:

The system covers juridical persons, including companies, commercial institutions, financial institutions, public enterprises, government departments, governments and similar institutions. It also covers singular or joint natural persons, if the facilities extended to them were of commercial nature (e.g. real estate mortgage loans or other financial investments), in addition to residents and non-residents whose availed credit facilities (funded or contingent) exceed AED 250,000 or equivalent thereof.

Borrower Details Required for This System:

Some of the borrower details required for this system is needed for RB use during the process of assigning code numbers and for the purpose of identifying and distinguishing borrowers' names. Others are required for providing indicators, which would help in giving a clear picture of the borrower's financial position.

The identification particulars used in this system are fit for use in cases of both individual and corporate borrowers according to the following details:

Business Sector Individuals (for commercial purposes)

1- Borrower's Name Borrower's Name

2- Ownership & Percentages Guarantors

3- Place of Incorporation Nationality

4- Date of Establishment Date of Birth

5- Municipality License Number Passport Number

6- Capital & Reserves Annual Income

7- Type of Activity Purpose of Loan

8- External Auditor Employer

9- Extended Facilities Extended Facilities Limit O/S

Funded Contingent Funded Contingent Total

10- Provisions & Suspended Interest Provisions & Suspended Interest

11- Summary of Securities in Hand Summary of Securities in Hand

12- Classification of Facilities Classification of Facilities

System Operation:

All member institutions mentioned above shall deal with the system in accordance with the following mechanism:

1- Data and information on the borrower shall be input on the same day in which facilities are sanctioned, through a specially designed computer screen; part of a program, which shall be made available to all member institutions by the Central Bank.

2- RB shall assign an appropriate code number for the borrower, along with a special code number for partners, and shall communicate it to the reporting agency.

3- Soon after receiving the code number from RB the reporting agency should enter the site of this customer, using the code number provided to it or by inquiring about the customer's name, and print out a statement including all inputs and keep it in the customer's file. Central Bank examiners will ensure that such procedure was performed during their routine examinations.

4- Beneficiaries of this system shall be entitled to enter RB database at any time to add, delete or amend data relating to their customers only. Prior approval of the Central Bank's Banking Supervision & Examination Department may be required in respect of certain amendments such as reducing provisions or suspended interest, or upgrading classification of facilities.

Advantages of the System

1- The system will save the time consumed in exchanging routine correspondence between RB and banks.

2- The system will ensure constant provision of updated information on borrowers, along with the potential capability of obtaining consolidated data at any time.

3- Data and information obtainable through this system shall be provided in both Arabic and English, hence ensuring flexibility for member institutions' staff in dealing with the system.

4- The system of instant reporting on a borrower, and the appearance of his name (on line) immediately after sanctioning will do away with the current system's shortcoming of holding the name for a period which used to extend as long as four months.

5- This system will provide abundant information on the borrower and would allow beneficiaries to obtain various types of consolidated reports, which may be summarized as follows:

- Total credit facilities extended to one borrower by all financing institutions operating in the country.
- The number of banks and finance institutions the borrower deals with Total provisions and suspended interest relating to the borrower.
- The lowest classification assigned to the borrower.
- Statement of the borrower's related and affiliated accounts.

Security & Confidentiality:

Each member institution is entitled to access the database, review details of all reported borrowers and extract reports whenever they wish. Such facility however, requires that management of the institution establish maximum security measures to ensure that only authorized persons have access to the system. They should provide the Central Bank with an undertaking to the effect that confidentiality of the data they have reviewed shall be maintained and that such data shall not be used for purposes other than those they were intended for.

Optimum Utilization:

The Central Bank expects that member institutions shall be keen on optimum utilization of the new system. This however may only be realized under the following conditions:

1- Devoting full attention to each and every stage of the system's operation, particularly the data entry stage, which is considered the cornerstone of the system's functioning. The more each member institution ensure that the entered data (inputs) are complete and correct, the more accurate and complete shall be the reports obtained from the system (outputs). In this context, we refer in particular to reports that show the borrowers related accounts, which would be processed electronically by the computer based on the names entered to the owner or partners column. Therefore, the lending agency must be keen to know the real owner and partners based on the documents to which they have been provided access, and not rely on names mentioned in the trade license, which often differ from reality.

2- Seeking to maintain accuracy and objectivity while filling- in data, regardless of any other considerations.

3- Maintaining constant follow up of borrowers positions utilizing the (on line) nature of the system which provides for amendment data at any time.

4- Utilizing the numerous indicators provided by the system in order to reach to an ideal assessment of the borrower. Apart from the total facilities extended to the borrower, the system also provides the number of banks he deals with, total provisions and suspended interest, classification of the facilities and also all related accounts. Hence regular follow up and analysis of these indicators would enable the institution concerned to read warning signs and take precautionary measures at the right time.

-Implementation

The Information Technology Division of Central Bank of the UAE has developed the basic software for this system. The Central Bank will provide banks, finance companies and investment companies operating in the country with all programs, operation manuals and applicable instructions, which would ensure proper functioning of this system. The Central Bank also intends to organize user-training workshops for the concerned staffs of member institutions.

2. Returned Cheques System:

The Returned Cheques System "RCS" at the Risk Bureau is an online database containing names of persons and commercial establishments whom 4 or more cheques are returned during a year.

Data are entered by authorized staff at the Risk Bureau based on a standard form completed by banks and financial institutions in the UAE, along with other required documentation such as photocopy of the person's passport or the trade license in case of commercial establishments, in order to ensure accuracy of data. Accounts of such persons and commercial establishments are closed and shall be banned from opening current accounts and receiving cheque books for one year.

This system allows banks and financial institutions operating in the UAE to review details of individuals and establishments listed in the system as a prudential procedure.

3. Customer Rating System (Personal Loans - AED 0- 250,000):

The Customer Rating System (Personal Loans) "CRS" at the Risk Bureau is an online database consisted of names of individuals rated by banks as customers who failed to honor their obligations towards those banks. Being an online system the CRS allows banks to instantly review lists of names and their respective ratings before sanctioning loans. Banks may access the system from their head offices and add new names or delete names. The CRS database is updated on daily basis. (http://www.centralbank.ae/, 12-10-2014).

5.2-Emirates Islamic Bank:

Emirates Islamic bank was launched in 2004, the bank was established to deliver the high standards of sharia principles. Offering abroad range of products designed for individuals and small business as well as large corporations.

5.3. The relationship between Emirates Islamic Bank and Central Bank of United Arab of Emirates.

5.3.1. The instrument controls of central bank on Islamic deposits are:

1-quantity methods:

A- Reserve ratio

b- Legal liquidity ratio

2-quality methods:

a-Determine the liquid funds that must be held by banks.

b-determine the funds that inter in liquidity ratio

5.3.2. The instruments control of central bank over credit banking by using quantity and quality methods:

1- The quantity methods :
   A-rediscount rate

B-open market operation

C-change the reserve ratio

2- The quality methods:

A-determining margin ratio required in the funding process margin

B-change the interest rate on certain types of loans

C-statement about the risk banking

5.4. Studying regulatory impact for the U.A.E central bank by application on annual report of emirates Islamic bank.

5.4.1. Finding and Results:

Given that the deposit according to the law is the amount of money betray bay and means of payment one person to another person committed to push on demand or according to the terms agreed upon deposit and acquire the depositor has ownership of money deposited and will have the right to dispose of it with a commitment to return the same currency type. We are now trying to illustrate the most important types of financing and investment in the Emirates Islamic bank (financing receivables).

Table (5.1): the Most Important Types of Financing and Investment in the Emirates Islamic Bank

Financing receivables	2013 1000 DHR	2012 1000DHR
Murabaha	1,3,858,119	9,705,333
Ijarah	9,417,915	8,957,451
Istisna'a	1,252,003	1,119,978
Financing wakala	855,658	2,193,085
Musharaka	133,384	161,800
Mudarabah	192,072	83,805
Secured over drafts	224,552	227,359
Credit and receivables	988,558	954,366

Table (5.1) the annual report for the ended period 31-12-2013 and 31-12-2012 for emirates Islamic bank p.37.

From the table (5.1) we note that the greatest amount of activity is murabaha .and as we know that financing by murabaha is the most important in Islamic bank investment, and this investment has a biggest role in money supply more than musharka and mudrabah.

The amount of murabaha in 2013 was (1, 3,858,119) and there is a development comparing with 2012becacuse the amount was about (9,705,333).

After, murabaha comes ijarah and then, credit and receivables,next comes financing wakala etc…..

Table (5.2): Reserved Account in U.A.E Central Bank.

	2013 1000DHR	2012 1000DHR
The amount of reserved account in U.A.E central bank	228,936	214,987

Table (5.2) the annual report for the ended period 31-12-2013 and 31-12-2012 for emirates Islamic bank p.38.

In accordance with the Bank's Articles of Association, Article (82) of Union Law no. 10 of 1980 and Federal Commercial Companies Law, the Bank transfers 10% of Shareholders' net profit for the year, if any, to the statutory reserve until such reserve equals 50% of the paid-up share capital. This reserve is restricted and is not available for distribution.

According to the table (5.2) there is a development in the amount of reserve account in 2013 compering with 2012.

Table (5.3): The Relation between Reserved Account and Profit in Period 2005 to 2013

YEAR	RESERVED ACCOUNT	PROFIT
2013	2,129,578	139,488
2012	1,761,056	81,112
2011	1,043,331	448,552
2010	1,008,738	61,262
2009	946,291	(18,857)
2008	1,089,900	400,583
2007	758,158	238,533
2006	389,876	117,460
2005	192,024	43,080

Table (5.3) the annual report for the ended period 31-12-2013 and 31-12-2012 for emirates Islamic bank p.37.

By analyzing these data in statistical program SPSS that there is an inverse and weak relation between cash reserved account in the U.A.E central bank, that emirates Islamic bank puts in central bank and profit in emirates Islamic bank and this relation is not significant and the value was about (-0.0552).

It can be represented this relationship through this function:

Y=21935456 _0.0552X.

Table (5.4):

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.232[a]	.054	-.081-	168728.685

a. Predictors: (Constant), X

Table (5.5):

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	11323823448.325	1	11323823448.325	.398	.548[b]
	Residual	199285584195.898	7	28469369170.843		
	Total	210609407644.222	8			

a. Dependent Variable: Y

b. Predictors: (Constant), X

Table (5.6):

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	219358.558	99082.508		2.214	.062
	X	-.055-	.088	-.232-	-.631-	.548

a. Dependent Variable: Y

Table (5.7): The impact of current account on emirates Islamic bank in the U.A.E central bank over profit in emirates Islamic bank.

YEAR	CURRENT ACCOUNT	PROFIT
2013	335,683	139,488
2012	104,152	81,112
2011	37,096	448,552
2010	24,508	61,262
2009	946,291	(18,857)
2008	472,935	400,583
2007	53,860	238,533
2006	5,837	117,460
2005	192,024	43,080

Table (7) the annual report for the ended period 31-12-2013 and 31-12-2012 for emirates Islamic bank p.37.

By analyzing this data in statistical program in SPSS. We find that there is an inverse and weak relation between current account in the U.A.E. central bank and profit in emirates Islamic bank, and the value (-0.24) and this value is not significant

Table (5.8): Regression

Variables Entered/Removed[a]

Model	Variables Entered	Variables Removed	Method
1	Current account	.	Enter

a. Dependent Variable: profit

b. All requested variables entered.

Table (5.9): **Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.245[a]	.060	-.074	168178.303

a. Predictors: (Constant), current account

Table (5.10):**ANOVA[a]**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	12621816046.261	1	12621816046.261	.446	.526[b]
	Residual	197987591597.961	7	28283941656.852		
	Total	210609407644.222	8			

a. Dependent Variable: profit

b. Predictors: (Constant), current account

Table (5.11):

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	199017.083	72874.483		2.731	.029
	Current account	-.129	.193	-.245	-.668	.526

a. Dependent Variable: profit

Table (5.12): The impact of reserve account over the volume of trading

YEAR	The volume of trading	Reserve account
2013	3058961	2,129,578
2012	2004695	1,761,056
2011	1195167	1,043,331
2010	1121466	1,008,738
2009	1161562	946,291
2008	1643918	1,089,900
2007	867912	758,158
2006	453337	389,876
2005	238858	192,024

Table (5.12) the annual report for the ended period 31-12-2013 and 31-12-2012 for emirates Islamic bank p.37.

By analyzing this data in statistical program we note that there is positive relation between the volumes of trading U.A.E. central bank with Emirates Islamic bank and cash reserved account ,and this relation With a significant effect and statistically significant ad positive impact . We can represent this relation by this function

Y=1164019.902+0.584X.

It means wherever the volume of trading increased about (1164019.902) the current account will increase about (0.584).

Table (5.13): REGRESSION

Variables Entered/Removed[a]

Model	Variables Entered	Variables Removed	Method
1	Reserve account[b]	.	Enter

a. Dependent Variable: the value of trading

b. All requested variables entered.

Table (5.14):

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.892[a]	.795	.766	412182.069

a. Predictors: (Constant), reserved account

Table (5.15):

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	4609969204114.514	1	4609969204114.514	27.134	.001[b]
	Residual	1189258408677.488	7	169894058382.498		
	Total	5799227612792.001	8			

a. Dependent Variable: the value of trading
b. Predictors: (Constant), reserved account

Table (5.16):

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	267051.203	242045.584		1.103	.306
	Reserved account	1.115	.214	.892	5.209	.001

a. Dependent Variable: the value of trading.

5.4.2.Conclusion:

1-There is an impact of the U.A.E central bank polices on the emirates Islamic bank performance.

2-the central bank oversight of deposits and credit in Islamic banks and use the same tools and methods used in the control of conventional banks.

5.4.3. RECOMMENDIATION:

At the end of this research we would like to present a group of recommendations the Islamic banks would like the central bank to take in to consideration to put for word new policies that will help the Islamic banks to improve its conditions:

1- adopting the obligatory reserve ratio regarding current deposits for the Islamic banks like the traditional banks while those related to the Investment accounts it must be Decreased because the Islamic bank doesn't guarantee its Deposits and Putting forward a plan for calculating liquidity ratio in away suiting the Deposits and assets dealt with by Islamic banks.
2- Taking into consideration any alternative standards and Instruments regarding the creditor role according to Islamic laws principles and providing the

necessary facilities as good loans when necessary so if the liquidity position still a problem or there is a surplus the Islamic bank will provide it as a good Debt for the central bank as it is and for the sure penciled too.

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APPENDIX A

Glossary of Technical Terms:

"Fiqh"	Muslim jurisprudence or Islamic law, the science of Sharia', covers all aspects of life, religious, political, social or economic. In addition to religious observances (prayer, fasting, zakat and pilgrimage) it covers family law, inheritance, social obligations, commerce, criminal law, constitutional law and international relations, including war. The whole corpus of fiqh is based primarily on the Quran and the Sunnah and secondarily on ijma and ijtihad.
"Halal	Anything permitted by the Sharia'. The concept of halal has spiritual overtones. In Islam there are activities, professions, contracts and transactions which are explicitly prohibited (haram) by the Quran or the Sunnah. Barring these, all other activities, professions, contracts, and transactions etc. are halal. In Islamic economics, other factors, mostly spiritual and moral are also involved. An activity may be economically sound but may not be allowed in the Islamic society if it is not permitted by the Sharia'
"Ijara"	Letting on lease. Sale of a definite usufruct of any asset in exchange of definite reward. It refers to a contract of asset leased at a specified rent payable in cash and also to a mode of financing adopted by Islamic financial institutions. It is an arrangement under which the Islamic banks lease equipments, buildings or other facilities to a client, against an agreed rental
Istisna'	A sale transaction where a commodity is transacted before it comes into existence. It is an order to a manufacturer to manufacture a specific commodity for the purchaser. The manufacturer uses his material to manufacture the required goods. But it is necessary for the validity of istisna' that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them

“Mudaraba	A form of partnership where one party provides the funds while the other provides expertise and management. The investment comes from the first partner who is called “Rabb-ul-Maal” while the latter is referred to as the “Mudarib”. Any profits accrued are shared between the two parties on a pre- agreed basis, while loss is borne by the provider of capital.

“Murabaha”	Literally it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and profit. This has been adopted by Islamic banks as a mode of financing. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost.
“Musharaka	Musharaka means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. 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.
Qard Hassan	A loan extended without interest in which the benefit to be derived is gifted by the owner to the beneficiary
“Salam”	Mode of financing in which the seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The price is in cash but the supply of purchased goods is deferred
“Sharia	Islamic law or jurisprudence. Divine law consisting of Quran and Sunnah as well as justification.
“Sukuk”	Islamic bonds

(Asian Development Bank, 2009).

ÖZGEÇMİŞ

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