Establishing the Need and Suggesting a Strategy to Develop "*Profit and Loss Sharing Islamic Banking*" (PALSIB)

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ABSTRACT

Contemporary Islamic banking claims to eliminate riba but largely depends on debt like financing techniques which allows it to assure sure and stable rates of returns to its depositors. However, for those critics for whom Islamic banking always meant doing business on profit and loss sharing basis, Islamic banking has failed to achieve this goal. On the other hand there have been renewed suggestions for taking out bank-interest from the definition of riba. Many Muslims are simply confused with all these divergent views. This paper takes an issue with the claim that riba means very high level of interest or usury. It also criticizes the use of debt like financing by contemporary Islamic banks. It argues that neither the Islamic banks nor the governments of Muslim countries have done enough work to promote profit and loss modes of finance. Apart from a suggestion for the creation of dividend markets parallel to conventional stock markets, the paper numerates a number of steps that must be taken for establishment of profit and loss sharing Islamic banking (PALSIB).

1. Introduction

The condemnation of *riba* is unequivocal and severe in the Holy *Qur'an*. The overwhelming majority of Islamic religious scholars as well as Muslim economists regard bank interest as *riba*. Elimination of interest has thus been the *raison d'etre* of Islamic banking movement. To replace the practice of interest by commercial banks, religious scholars and Muslim economists had initially called for establishment of Islamic banking system, preferably based on profit and loss sharing modes of financing, *mudarabah* and *musharakah*. But they also allowed some other modes of financing such as *ijarah*, *ijarah wal iqtina*, *bai salam*, *murabaha* and *bai muajjal*[1]. Over the last three decades there has been a mushroom growth of Islamic banks and a remarkable increase in their deposits. However, most Islamic banks are heavily dependent on 'debt like' modes of financing for their earnings. These modes of financing involve different forms of selling goods on a deferred payment basis with higher than cash price. A number of Islamic banks have also adopted a mechanism that allows them to give cash loans (*bai einah*). For many Muslims the whole enterprise of present Islamic banking thus seems to be mired with widespread confusion.

Some Muslim economists are particularly dissatisfied to observe that Islamic banking has not led to any significant outcomes that could be proudly presented as a real and different alternative for conventional banking. Different reasons and arguments are given for this state of affairs by Islamic economists and Islamic banking practitioners. Many among the former criticize that current Islamic banking has ignored basic rational and theoretical underpinnings of Islamic banking such as distributive justice and financial stability (among others). On the other hand, Islamic banking practitioners point out the difficulties they face in utilizing their deposits in profit and loss sharing techniques of finance in an extremely competitive industry of commercial banking. Furthermore, many of them also claim that as the Islamic banks' products do not involve interest, even if they may be appearing to be using debt like transactions, in principle they are not violating any *Shari'ah* rules. Instead, by providing an alternative to interest they are fulfilling a religious obligation and allowing Muslims to follow the teachings of Islam in financial dealings. Furthermore, one can also claim that Islamic banking has allowed the resources of the Muslims community to remain in the hands of financial institutions run by Muslims.

The majority of the contemporary religious scholars and Muslim economists treat extra earnings (over and above the profit that could be made through sale of a good on cash price) from debt like financing such as *murabaha* and *bai muajjal* permissible, and allow its unlimited use by Islamic banks. The original proponents of Islamic banking, for whom Islamic banking always meant *profit and loss sharing banking*, have gone into the background. The most prominent players in the field are the members of the *Shari'ah* Boards of different Islamic banks. Their main function is to give verdict, largely based on selective juristic rulings of the past, on the validity of Islamic banking products. They seem to be less concerned either about the (questionable) validity of those rulings then and now, or the ultimate effect of these rulings in the contemporary Muslim economies. The issue of time value of money has also caused Muslim scholars to tremble. They find it difficult to explain why the concept of a positive time value of money is acceptable in case of sale on credit with higher than cash price, but denied the same in cash loans.

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[1] Throughout this paper, *Bai Muajjal* is used to refer sale on credit with <u>a price higher than the cash price</u>.

There is another group of scholars who, following Sheikh Abduh, Professor Fazlur Rahman and some others, have recently argued against treating bank interest as *riba*.[2] The fact that elimination of interest remains the main reason for the establishment of Islamic bank, it is important to evaluate and respond to such arguments. As Fazlur Rahman's (1963) ideas remain one of the most quoted ones, I intend to do a more detail analysis of his arguments.

The other goals of this paper is (i) to criticize the current status of Islamic banking for its use of debt like financing by questioning the validity of its products notwithstanding its permissibility granted by the past *fuqha* and their contemporary followers (ii) to emphasize the benefits of alternative PALSIB as well as the problems associated with it, and finally (iii) to give a number of suggestions for a successful establishment of PALSIB.

The organization of the paper is as follows. Section two is devoted to issues related to *riba* and interest. It critically evaluates the soundness of the arguments that are advanced against treating bank interest as *riba*. In section three the permissibility and/or desirability of *murabaha* or *bai muajjal* (sale with deferred payment on higher than cash price) is analyzed. In section four the current status of Islamic banking is presented briefly. Section five discusses a number of suggestions for meaningful implementation of profit and loss sharing banking. A conclusion is made in section six.

2. Is Bank Interest not *Riba*?

Riba has always been an important issue for Muslims of all eras. The reason for this is the indisputable and severe warnings given in the *Qur'an* against its practice. There is no disagreement on the unlawfulness of any transaction that involves *riba*. However, there is some controversy and significant confusion revolving the issue of bank-interest as it has been practiced for several centuries all over the world. In this section I will present and criticize the main arguments against inclusion of bank interest in the definition of *riba*. I will also try to give more importance to the verses of *The Qur'an* than to Ahadith which should, in my opinion, always be the case.

Let me start with mentioning the verses of *The Qur'an* that are related to *riba* in chronological order:

> 1)
> So give to the kinsman his due, and to the needy, and to the wayfarer. That is best for those who seek Allah's countenance. And such are they who are successful.
> That which ye give in usury in order that it may increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's countenance, hath increase manifold.
> (30: 38-39) Translation by Marmaduke Pickthall.
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> 2)
> Because of the wrongdoing of the Jews We forbade them good things which were (before) made lawful unto them, and because of their much hindering from Allah's way: And of their taking usury when they were for bidden it, and of their devouring people's wealth with false pretences.
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> We have prepared for those of them who disbelieve a painful doom.

[2] For example, Sayeed (1996 & 1998) and Farooq (2006).

(4: 160-61) Translation by Marmaduke Pickthall.

3)
O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful.
(3: 130) Translation by Marmaduke Pickthall.

4)
Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord commeth and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affairs (henceforth) is with Allah. As for him who returneth (to usury) - Such are rightful owners of the Fire. They will abide therein.
Allah hath blighted usury and made almsgiving fruitful. Allah loveth not the impious and guilty.
Lo ! those who believe and do good works and establish worship and pay the poor-due, their reward is with their Lord and there shall no fear come upon them neither shall they grieve.
O ye who believe! Observe your duty to Allah, and give up what remaineth (due to you) from usury, if ye are (in truth) believers. And if ye do not, then be warned of war against you) from Allah and His messenger. And if ye repent, then ye have your principal (without interest). Wrong not and ye shall not be wronged. And if the debtor is in straitened circumstances, then (let there be) postponement to (the time of) ease; and that they remit the debt as almsgiving would be better for you if ye did but know.
(2: 274-80) Translation by Marmaduke Pickthall.

In his argument against treating bank interest as *riba*, Fazlur Rahman (1963) chose verse 39 of Ar-Rum, 130 of *Ale Imran* and 274-80 of Al- Baqra. In order to define *riba* he, however, gives main importance to verse 130 of *Ale Imran* where doubling and redoubling of the principal is mentioned. However, he fails to take full note of verse from *An Nisa* (number 2 above) where Jews' involvement in *riba* is mentioned. He only uses this verse to make an argument against the view that verses on *riba* in *Al Baqrah* were the last verses of *The Qur'an*. He argues that the verse in *An Nisa* were revealed during the capture of Khyber that occurred in 5th Hijrah and according to him, they could not be condemned for dealing in *riba* when *riba* was not made haram in *The Qur'an* itself. Fazlur Rahman had to make this argument to question the validity of the report attributed to Caliph Umar that the verses on *riba* in *Al Baqrah* were among the last verses of The *Qur'an* and the Prophet died before explaining the full implications of those verses. Fazlur Rahman has to do this in order to prove his case that it was clear to every body that the *riba* condemned in those verses were the doubling and quadrupling *riba* of *jahiliyya* and not *any* increase in the amount lent.

One cannot be sure why Fazlur Rahman failed to give due importance to verse from *An Nisa*. Only Allah knows the best, but one probable reason could be that it would make his understanding of *riba* weaker. It would be difficult to claim that throughout their history and up to the time when *The Qur'an* was being revealed Jews were always involved with only doubling and quadrupling usurious dealings. But the logical mind of

Fazlur Rahman could not resist conceding that in order to avoid *riba* from a system, the distinction between high and low rates of *riba* had to be removed:

> "A natural question arises here, viz., if riba is only that part of usurious transaction that has been described above (doubling, quadrupling) and if only this form is banned then, then why is that, as an effect of the *riba*–ordinance of the *Qur'an*, *all* interest seems to have been abolished as is, indeed, testified by historical evidence? The answer to this is that we do not hold that in each and every given case of loan, the capital was thus doubled and redoubled --- indeed, there must have been a great deal of variation in individual cases depending on circumstances, e.g. the nature of investment, the amount of risk, etc. But what matters is that all these individual cases were part of a one riba-system in whose nature it was to be so exorbitantly usurious. Therefore, what had to be banned was the *system as a whole*, and hence no exception could be made in individual cases. When the entire system was banned, the milder cases within that system were also naturally abolished since the system itself was tyrannical." Rahman (1969, p. 7 – words in parenthesis added by me).

Rahman, however, quickly adds that:

> "It cannot, therefore be argued that since the *Qur'an* abolished even the milder cases, it must be concluded that bank-interest of today also stands condemned. This is because bank-interest of today is a separate kind of system." (Rahman, 1969: pp. 7-8).

Rahman then claims that bank interest is the price of credit, just as price of any other thing and that taking price to zero would create a huge gap between demand and supply thus loosing a mechanism of credit rationing that is facilitated by the institution of bank interest.[3] He then also claims that the price of credit, interest rate, is not arbitrary and is fairly stable unlike prices of other goods and services. It is determined through many complex economic factors and any change in this price is itself a result of changing economic conditions. Finally, he mentions that some economists believe that the interest rate could be brought to zero provided that the level of wealth could be increased sufficiently but he also noticed that the interest rates in wealthy countries had not come close to zero even though they experienced a declining trend.[4]

Writing his article in Pakistan in 1963, Fazlur Rahman argued that compared to abolishment of bank interest, landlordism, hoarding and profiteering were much more rampant and required urgent attention for eradication of injustices in that Muslim society. I would have no argument with him on this last point.

Fazlur Rahman was not an economist and I don't think one has to be an expert in economics or finance to comment on some basic economic phenomenon specially if relates to justice and fairness. Economics and especially political economy affects everyone in the society and anyone can form genuine opinion on related issues. However, several points are worth mentioning here:

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[3] Rahman (1969, p. 37).

[4] Ibid., p. 38. This was an idea also thought about by Keynes who vehemently criticized the institution of interest in his *General Theory* and in the final chapter of that book suggested that if supply of loanable funds were not enough through private savings, public savings could be extended to the level where provision of any positive return on savings would become unnecessary. In his later years, however, Keynes also treated interest rate a reward for parting liquidity.

Bringing a kind of equilibrium between demand and supply appears to be a major concern for financial intermediation. However, for the economy as a whole, the more important thing is an appropriate level of investment and economic activities that maintain full employment with negligible rates of inflation. Extending funds only on profit and loss sharing basis does not mean that each and every business proposal has to be accepted. Funds will only be available for projects and businesses where expected return is positive, and projects and businesses with higher expected returns will be financed first. The goal is to keep economic and activity at full employment level with negligible inflation. Any excess demand for funds at this stage (nearing full employment) has to be ignored. A lack of demand for funds before full employment is reached is a problem in the conventional system and could remain so in the Islamic system. It has to be tackled through different means (for example, through tax incentive).

It should be conceded that among many other things, nominal rate of interest does have an effect on business activities. It is often raised to curb inflation and reduced to stimulate the economy. If the main job of the central bank is to maintain price stability, it tries to raise or lower interest rate accordingly. However, it cannot curb economic activities in a booming economy as increase in interest rate will not necessarily reduce money supply if the demand for investible funds remains strong together with the willingness of the banks to go along with their sentiments. Similarly, a mere decrease in interest rate may not stimulate the economy if other bottlenecks are not removed. The primary variable that influence rate of inflation is stock of money and as we explain below, under PALSIB the central bank can directly control the supply of money without the availability of interest rate variable by reducing or increasing the level of money they would keep in each PALSIB banks.

Milton Friedman has been rightly credited for establishing the link between money stock and inflation and the need to follow a monetary rule than to use discretionary monetary policy. For him, leaving the money supply grow in line with the growth rate of the economy, any excess demand or supply of money could be eliminated through market determined rate of interest and did not need the involvement of the central bank. In Friedman's scheme a recession due to falling profits of businesses would be corrected through a general decline in prices including wages. This idea was criticized with the famous argument that prices and wages are generally inflexible downward and a long period may be needed to bring back the economy on the right track. In an Islamic financial system the effects of declining profits and a slowing economy could be automatically and immediately absorbed by all providers of funds, big or small. It would differ from Friedman's suggestion in that the rate of return (Friedman's interest) would be post determined. It is now well argued that the institution of bank interest allows banks to be less prudent during booming condition. The certainty of getting back their principal as well as the interest accrued, encourage them to be less prudent and get along with, what Keynes had termed, the animal spirit of their borrowers.[5]

One should also admit the difference between getting interest rate to a zero level and investing funds on a profit and loss sharing basis. In the interest system, business projects are undertaken only if the project is expected to yield a rate of return higher than the rate of interest whereas in a profit and loss sharing system all projects could be undertaken where the rate of return is above zero. Therefore, in theory, it is true that the

[5] For a full discussion of this issue please see Fardmanesh and Siddiqui (1994).

demand for and supply of funds would be relatively greater in a profit and loss sharing system. But there is no reason to believe that the profit and loss sharing system would create an *undesired* gap between demand and supply. Of course, in both systems projects with higher expected return with same level of risk would be taken first.

Before I take on some other arguments in favour of bank interest, let me point out something that came to my mind regarding rampant consumerism made possible through institution of interest when I recently read verse 39 of *An Nisa*. Here Allah *Subhanautaala* is reminding the people who pay an extra amount on loan that they may think that they are benefiting the lenders but in the eyes of Allah there is no increase; neither the borrowers nor the lenders benefit from this deal. But any one who gives away someone without any hope of return from him, has a great reward waiting from his creator! Now look out our condition today. Today we don't mind paying an extra payment for what we borrow for consumption (often more than what is essential) but often find ourselves little room for paying our *zakat* and *sadaqat* in a satisfactory way.

Sheikh Dr. Tantawi and Sheikh Wasil (previous and current Muftis of Egypt) claim that conventional bank interest is a share in the profits of growth inducing investment, and not the prohibited *riba*.[6] Indeed, their assertion will be justified if it could be proven that interest is paid to the depositors of banks as a share in the profits of banks, who in turn earn their profits through investing their own funds and those of their depositors in business and productive activities on profit and loss sharing basis. Needless to say that it is not the case. For the students of history of economic thought, it would be interesting to note that the leading philosopher of political economy of the classical era (1776-1850), including Adam Smith and Ricardo, had similar views on interest. They developed theories of wages, rent and profit but did not realize the need to offer a separate theory of interest. For them, interest was paid out of profit but never tried to answer whether interest should be paid if no profit was realized or what would be the rationale for charging interest on consumption loan. Answer to these questions required a theory of interest attempts for which were made later, the most important among them being Bohm Bawerk.[7]

In 1889, the Austrian economist Bohm Bawerk argued that people have defective imagination. They generally fail to visualize their future wants.[8] People underestimate future needs because they have defective imaginations, because they have limited will power and cannot resist present extravagance even when they are aware of future needs, and because they know the life is short and uncertain and therefore wish to enjoy life today rather than sacrifice for tomorrow. He claimed that this is the only irrationality he had generally found among otherwise rational people. He regarded this time preference as one of the reasons for payment of interest to those who give loans.[9]

According to Bohm Bawerk, apart from time preference, there are two more reasons for payment of interest. One other reason for payment of interest, that is also subjective like time preference, is the prospect of increasing income for borrowers in the future. As many people expect that their income would be increasing in future, they are ready to borrow and pay interest that allows them to consume something earlier. For

[6] Please see El-Gamal (2001), p 2.
[7] For a brief summary of these theories in chronicle order, please see Siddiqui (2006).
[8] Fredrick et al, p. 354.
[9] Brue (2000), pp. 266-67.

Bohm Bawerk the only objective justification for payment of interest was that the saved money could be utilized in round about production method that generally produces a profit.[10]

From an Islamic point of view, there is no problem with Bohm Bawerk's objective justification for interest if it is paid out of *realized* profits as a percentage if the provider of fund was ready to bear the losses accordingly. The other two justifications are based on subjective notions and could be contested even without a reference to Islamic teachings. Again from an Islamic point of view, even if the borrower could pay an extra amount on loan, it is neither justified for him nor for the lender to ask for any extra amount.

Siddiqui (2006) shows that to get income (not consumption) *earlier* is only *indirectly* related to time: to avoid uncertainty of payment or to avail an investment opportunity in the future. It is not that people prefer present consumption to future consumption in general. But there are some other factors which influence their decision to receive, if possible present income (not necessarily present consumption) sooner than later. His result is in conformity with a comprehensive survey article on time preference by Frederick et al (2002) who have also concluded that what is being labeled as discounting of future payments and time preference could actually be a reflection of avoidance of uncertainty or impact of inflation or missing an investment opportunity or a combination of these and more factors.[11]

Abdullah Saeed, in his book "Islamic Banking and Interest: A Study of Prohibition of Interest and its Contemporary Interpretation", has also criticized the idea of treating bank interest as *riba*. His major points could be summarized as follows:[12]

1) The prohibition of *riba* in The *Qur'an* is about the *jahiliyya* practice of very high level of interest (doubling and quadrupling the loan amount) charged by the lenders that often led to enslavement. The economy was mainly an economy of subsistence and basic needs. Today, debt is not necessarily associated with poverty. This is particularly true of large scale borrowing for the production of goods and services or for the purchase of durable goods.
2) There are laws to protect borrowers, particularly small scale ones when they default on their debts. The debtor may neither be enslaved nor forced into bonded labor. Besides, transferring debts from parents to children does not exist today because the debtor can declare bankruptcy which is also a well known institution in Islam. The current levels of interest charged by commercial banks do not come to usurious level and hence does not constitute *riba*.
3) Risk is not necessary to earn an income. For example earning predetermined income through wages and rent are permissible in Islam. Also, some financial transactions do not involve risk (such as *murabaha*) but the income generated through them is justified by the old and contemporary *fuqha*.
4) The *ahadith* related to *riba al-fadl* cannot be used for justifying prohibition of interest as these *ahadith* are not about loan but refer to some trade practices.

[10] Ibid.
[11] Frederic et al (2002), pp. 381-83.
[12] These points are largely taken from the commentary on Abdullah Saeed (1996) by Al-Misri …………

5) Many old and contemporary *fuqha* disallow charging any level of interest but approve transactions that allow charging of the same through back door. This is equivalent to *hiyal*.

First of all, we have no dispute with the last two arguments. The argument that *riba* was only prohibited because it affected only the poor people in distress, is very meticulously refuted by many writers. For example, Fazlur Rahman (1958) gives an excellent account of the situation prevailing in Arabia when the prohibition of *riba* came.[13] Extensively quoting from the analyses of western scholars on Islam as well as writings of early Islamic scholars he convincingly shows and leaves no doubt that the loan on interest for commercial purpose was a normal practice at the advent of Islam. Indeed, the institution of *riba* then and now hurts the poor more than those who are not so poor. However, this does not imply that *riba* would become acceptable if loan is advanced to not so poor or rich.

The argument that wage and rent are also predetermined and fixed does not really require a refutation. Different types of workers are asked to carryout a particularly defined job which they do through their labour to earn an income for their livelihood. Their payment could not be made dependent on the outcome of the business they worked for unless they willingly agree to get any part of their income so linked. On the other hand, rent is the payment for the usufruct such as a machine or a building. The owner of the property allows the use of a valuable facility for a period of time to earn an income. He may or may not make an over all profit over the life of the property. The case of investible funds is different. It consists of savings made by surplus economic units in the economy. People including workers mainly save for future after meeting their present needs. This savings is then advanced to those who would use funds in expectation of generating income that would exceed the initial fund. However, this may or may not happen. If the returns are good that then it should be equitably distributed among the providers and the users of funds. If the returns are low and in some cases even negative, the losses should be also shared equitably. This is the fair system espoused by Islamic system.

Summing up this section, we think the basic issue is that of attitude: Why do we want be paid an extra amount when we give a consumption or business loan? One can understand that the lender takes a risk of default. If so he can refuse to lend but lending and asking for more is against the Islamic morality as it sows the seed of greed and selfishness. Finally, two quotes from the summary of the judgment made by the Federal *Shari'at* Court of Pakistan

> "The judgment brings ample evidence from historic sources that loans in vogue in the days of the Prophet (p.b.u.h.) were of commercial nature."
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> "The judgment also examined view point of a council which tried to confuse the issue by contending that '*riba*' falls into the category of 'Mutashabehat' and proved beyond doubt that the matter falls in the classification of 'Muhkamat', and being a clear *Qur'an*ic injunction (*Nas*) cannot at all be subjected either to 'Maslaha' or' ijtihad'."[14]

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[13] From India and not the same Fazlur Rahman extensively quoted above who was originally from Pakistan and later became a faculty member at the University of Chicago.

[14] http: *Shari'ah* Court of Pakistan on Interest-Free Economy, Jamaat-e-Islami Pakistan web site:

3. Higher Prices for Credit Sale Through *bai muajjal*, *murabaha* and *ijarah wal iqtina*

As mentioned in the introductory section, Islamic banks were established to eliminate interest from commercial banking (and this makes sense only when one treats bank interest as *riba*). However, from the very outset they were allowed to use *murabaha*, *bai muajjal* and *ijarah wal iqtina* (lease financing). In Pakistan where the whole banking system was supposed to be transformed into Islamic banking, it was believed that during the initial years of transformation, banks could not be expected to use profit and loss sharing techniques of financing and hence would require using these less desirable modes of finance. However, no time frame was envisaged or no written guidelines were given to limit the use of different financing modes. The result was that bank quickly started to use a version of *murabaha* where practically the term interest was replaced by mark up and the business continued as usual.[15] No wonder that nothing significant was achieved through transformation and eventually the banks even stop using the term Islamic banking. More or less the same thing happened all over the world. Now some Islamic banks give cash loans through dubious documentations. I am among the people who believe that this is worst than conventional banking as it is effectively the same transaction with a misleading Islamic tag.

The problem is that once we allow credit sale with higher than cash prices, the case against bank interest just does not hold. Muslim economists who accept the permissibility of sale on credit with higher than cash prices face tremendous difficulty in explaining why Islamic teaching which does not allow time value of money in case of cash loans, does allow the same thing in credit sale with higher than cash price. For example, Fahim Khan (1991), puzzled with the fact that some of the past *fuqha* had allowed *bai muajjal* with higher than cash price while they regard interest *haram*, suggest that the *fuqha* might only had allowed a different price for the future that could be more, or less, depending on the demand and supply situation for the commodity in future! However, one can find no evidence at all of such reasoning in voluminous Islamic literature of the past on this issue. Why did not M. Fahim Khan think that some of the past *fuqha* were simply wrong in their rulings? Similarly, another prominent Muslim economist Monzer Kahf tries to establish the validity of *bai muajjal* with higher than cash price by equating it to a *mudarabah* type transaction:

> "Trade has the same characteristic, that other production processes have, of ownership of goods with the intention of selling at a higher price than their cost. In *Bay Muajjal* and in *Salam*, the owner of investible funds incorporates his/her expected time value of money in the investment process he/she pursues. The fact that once a contact is concluded in a *Bay Muajjal*, we reach the *ex-post* evaluation of time preference does not change the nature of the process. In *Bay*

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http://www.jamaat.org/issues/*Shari'ah*hcourt.html (accessed on January 24, 2007)

[15] There is nothing wrong in the original concept of *murabaha* where one person who was expert in buying a good was asked to get the good and charge more than what he actually paid for the good. The extra payment was for the time he spent in using his expertise. So called Islamic banks have misused this concept of *murabaha* as they primarily finance something their customers already know about and the extra payment they pay is because of the delay in pay back the amount that was advanced by the banks to buy a product.

> *Muajjal* one begins by the mental operation of formulating an anticipated time value of money, then transforming funds into goods, owning them and then taking responsibility of one's ownership, then concluding a deferred payment sale which transform his/her expectation into an actual and final reality although this actual time value of money needs not be the same as the anticipated one. This process is essentially the same as *Musharakah*, *Mudarabah* and leasing."[16]

Kahf is trying to say that *bai muajjal* is like *musharakah* and *mudarabah*, the only difference being that in case of *bai muajjal* the expected time value of money contemplated by the seller becomes ex-post immediately. But this is the whole point; *mudarabah* and *musharakah* are different from debt financing only because the rate of return from these financing are unknown because of the uncertainty of the outcome involved.

Rafiq Al Misri on the other hand has the following explanation:

> "In a deferred payment sale, it is not possible to equate the seller with the usurer, even though the deferred payment sale in reality consists of a cash sale and a loan with interest. However, the seller himself combines these two activities in one activity, that is 'sale'. The seller in this case practices at least a commercial activity which is productive and recognised as lawful" (Saeed's quotation of Misri, Saeed (1998), p. 7)

The claim here is that the seller is involved here in an act of selling and hence in a productive activity. But why then it is regarded a sin when a bank advance loan to a factory which is also involved in production on the basis of interest? Or why the same bank is sinning when it gives a loan on interest to a student who wants to go for higher education that will make him more productive or give loan on interest to a sick person who would become more productive after medical treatment? The arguments are just invalid; to be consistent and reasonable, we either have to admit that interest is not *haram* or we must admit that *bai muajjal* with higher than cash price is also prohibited.

It is not that Islam does not care about time. There is no doubt that $100 today in my hand is not the same as $100 I have given to Mr. A who promises to pay it back to me after a year (ignoring the issue of inflation for a moment which is a different matter)[17]. There is uncertainty involved; the money may not be paid or I may need it very badly during the year or I may have a profitable business opportunity (even if the return on it is not guaranteed). These three elements make $100 today in my hand more desirable than the same in the hand of Mr. A who say he would pay it after a year. Of course, if I am myself in need of this money for my own consumption <u>*now*</u>, I would like this money to be with me which would show my preference for having this money or a positive time preference for this money. But this money could also be part of my savings that I would rather like to keep for my future needs in which case I would have a zero or even a negative time preference for these 100 dollars. Existence of positive time preference has nothing to do with interest as Robinson Crusoe would also have a time preference (by keeping more or less apples for tomorrow) even when he had no one to lend or borrow

[16] Kahf (1992), p. 36.

[17] Indeed I do consider demand for compensation for inflation by the lender is legitimate.

from.[18]

One should also be aware of the fact that there has been no *ijma* on the issue of *bai muajjal* with higher than cash price. Saeed (1998) has been fair enough to quote past *fuqha* who had conflicting opinion on this issue:

> "Many prominent early jurists seem to have refused to recognise that any increase in a loan or sale price can be justified on the basis of time, because time itself is not money or a material object that could. be a countervalue in a loan. …………
> In a sales transaction the Hanafi jurist Shaybani (d.189/855), for example, did not approve of selling at a lower price in cash in contradistinction to a higher price on credit. In the context of explaining the unlawfulness of making an earlier payment by the debtor against a reduction of the amount payable, Shaybani's view was that it is not good for the borrower because he expedites a lesser amount in cash against a larger amount on credit; or, if he is selling at a lower price in cash, against a higher price on credit (Anas, 1979: 271). Razi, in his commentary on *riba* verses, rejected the notion that 'time allowed for payment' can be a countervalue for an increase, because 'it is not goods or a thing which could be pointed at, to make ita countervalue' (Razi, 1938, VII: 97).
>
> This discussion indicates that many early authorities considered that a value cannot be assigned to time and, as a result, an increase cannot be demanded from the debtor on the basis of an extension given for payment. In the modem period, critics of *murabaha,* such as al-Kaff (al-Kaff, 1986: 12ff.), maintain that the increase against time would be *riba.* The Council of Islamic Ideology of Pakistan (CII) states that doubts might arise in relation to the increase the seller is receiving in the case of deferred payment sales (that it is against the time given to the buyer for payment), and, therefore, such increase may resemble *nba* (CII, n.d.: 36)." Saeed (1998; 12-13):

Indeed contemporary Islamic banks are trying to reduce their risk exposure and get a certain rate of return like the conventional commercial banks. Thus the concept of positive time value of money is becoming a natural phenomenon for them. One has to remember, however, that the positive time value of money cannot be think of without accepting the validity of a positive rate of interest. In this regard, we must understand the difference between time preference and time value of money. A positive time preference does not assume a positive rate of interest and it is not necessary that everyone in this world always have a positive time preference. There are plenty of empirical evidences that people do save part of their income for future even when the real interest rate is negative. Similarly, assume that we live in a country where interest rate is negative 4 % and people are so risk averse that they do not want to invest in any risky business venture? Do you think people will stop to save anything at all? If they do still save, which will certainly be the case, then can't we claim that people have negative time preference? To me, in the absence of inflation, 100 dollars today is certainly preferable to 100 dollars tomorrow if there exists a positive rate of interest and provided that I accept the legality of interest. However, I may still like to have my 100 dollars today rather than a year later because of the uncertainty, and also because I may prefer to invest the money (in the absence of sure positive return) in a risky business where expected rate of return is

[18] See Sugden and Williams (1978), p. 15, for this point.

positive. One can therefore at best claim that the money is expected to have a positive return over time but it could yield a negative return and in the absence of the institution of interest, the rate is not known in advance.

In a world with no positive rate of interest, when we give loan to somebody, there is no denial that we are potentially loosing a chance for a probable income or there is chance that the money will not be returned. We are not forced to give loan. There is no sin in not giving a loan. One can always refuse to give a loan even when he thinks that the borrower badly needs it, although there is a promise from our creator of a huge *ajr* (reward) for granting a loan even if there is a chance that the loan may not be returned. What is not permitted, however, is that we give a loan and ask for more than the amount of loan (except, in my view, a compensation for inflation).

4. Contemporary Islamic Banking

Contemporary Islamic banking has hardly achieved anything significant. By and large, using debt like transactions, it has contributed in the continuation of conventional commercial banking. As Saeed (1998) points out, Islamic banks have been pragmatic and avoided profit and loss sharing techniques of financing because of the inherent problem of risk involved mainly because of the problems of moral hazard and adverse selection.

For me, the argument that in contemporary societies the problems of moral hazard is insurmountable and banking with reasonable rate of interest is the only solution for the kind and level of financial intermediation provided by conventional banking, is much more acceptable than the claim that current activities of Islamic banks are in line with the spirit of Islamic teachings. Indeed, conventional commercial banking has its benefits and disadvantages. Our main objection against it is that it is based on something that is prohibited by Islam and our belief that its alternative based on a more justified system of profit and loss sharing must be more beneficial. That it would be difficult to be implemented is also not questioned. However, one must examine whether Islamic banks and the governments of Muslim countries have put reasonable effort to establish the system. After all, current conventional banking has been established after a long period of trial and error and had required many laws, regulations and development of necessary institutions (such as central banks, deposit insurance, etc.) for its health and survival. Neither the Islamic banks nor the governments of Muslim countries have taken the challenge of PALSIB seriously. On the other hand, not a single member of any *Shari'ah* Board of any Islamic bank has a member who questions the validity of debt like transactions.

It was expected that the position of ordinary depositors of commercial banks many of whom are unable or incapable of investing in other instruments of capital market, will be improved from the profit and loss sharing Islamic banking after effectively becoming shareholders of Islamic banks. However, it is quite evident that they are still treated as depositors of commercial banks. As they are more or less assured of their return (never mind if it remains meager!), they remain depositors like any other commercial bank.

As most Islamic banks have been heavily involved in consumers' loan, they have also joined hands with other commercial banks in spreading consumerism to new extents. Even a rich country like Brunei Darussalam where most of its Muslim customers do banking with Islamic banks, indebtedness has become a major social issue. Recently the government had to intervene and put a ceiling on the amount of loan that commercial banks (not excluding Islamic banks!) can give to government employees.

Looking at this situation one has to ask, what really went wrong? In my opinion the answer is that everybody involved in establishing Islamic banking, including the academicians, did not realize the complexity and enormity of the job at hand. The issue of moral hazard and adverse selection was not a new phenomenon in banking and it should have been visualized that it would take some time to overcome or control this problem. The sensible approach should have been taking a gradual and cautious approach. There was no need to give an impression to the Muslim depositors that returns on different types of deposits would be as good (if not better) than the conventional banks. Actually the funds could have been solicited only from committed Muslims and Muslim governments after giving a complete picture of the difficulties of the job at hand. The desire to keep the depositors happy and not deserting Islamic banks coupled with the unlimited availability of debt like financing and a somewhat sympathetic *Shari'ah* board (one for each bank!) led to the easy solution in which we find the Islamic banking industry today.

I don't see any hope that there will ever be a consensus against the validity of debt like financing. It is, therefore, suggested that instead of wasting time in continued arguments, the Islamic critics of contemporary Islamic banking should put all their efforts in working for alternative PALSIB as a variant of Islamic banking. We already have a fairly good idea as to what went wrong with the current Islamic bankimng; it would be now somewhat easier to take necessary steps to set the correct direction for the desired destination. That the road would be bumpy and movement could be slow is not disputed; right direction, steadfastness and keeping the destination clear in sight will eventually achieve the objective.

5. How to Establish PALSIB: Some Suggestions

There are four parties involved in commercial banking each with their own interest; funds providers (or savers), funds users, commercial banks and the government. The role of government is to make relevant rules and regulations and establish institutions for smooth running of the commercial banking, and to safeguard the interests of the bank owners (who provide initial funds or owners capital), funds providers, and the funds users. Furthermore, by allowing commercial banks to create money and empowering central banks to stand for them as the bank of last resort, the government has the right, responsibility and a stake in smooth running of the banking sector as the general public also benefit from the stable and growing level of economic activities partially made possible through financial intermediation.

A basic requirement for the eventual success of PALSIB is that all these four parties have enough commitment, compulsion and incentives to carry out what is required of them. There is no denial that some of them (especially the funds users), at least occasionally, following their instincts of self or group interest would tend to drift from the ideal. A necessary environment has to be created through rules, regulations and its implementation that could minimize such behaviors.

As mentioned earlier conventional commercial banks have grown over centuries creating many institutions to support its smooth running. Even now, in a free market era, they are the most heavily and extensively regulated industry constantly under watch by the central banks. The backbone of conventional banking is (a) the right of the depositors to their principal amount (up to a certain limit) in *nominal terms* and any interest accrued no matter what happens to a bank and its fund users, which necessitates (b) provision of loans to the funds users only against collateral. Both the depositors and banks thus are supposed to be risk averse by design. The banks are actually discouraged to offer higher rates of returns as it may require them to charge higher rates to their funds users raising the chances of higher incidences of business failures. The system has thus resulted in very low levels of assured returns to the depositors that, in many countries even do not reach to their rates of inflation. *This is a new kind of injustice that is often not given due consideration in Islamic banking literature*.

While assuring the depositors of their principal and interest accrued on them is the backbone of conventional banking, such assurance is a negation of PALSIB unless the amount is deposited as an *amanah* (safe custody) in which case the principal would be protected and a service charge for safe custody and other facilities imposed. There is a whole lot of difference in these two types of arrangements and requires a completely different and new approach of thinking, attitude, operative methods and supporting institutions to do this kind of banking. By doing banking with *murabaha* and its variants, not much was done to move in this direction.

5.1 Changes in Attitude and Approach

Perhaps the most important thing for PALSIB is the attitude of their bankers. They must be trained to do a different type of banking. Conventional banks are trained to ascertain the provision and value of collateral before giving a loan. PALSIB requires that they train their staff for evaluating the fund users (more importantly their integrity and capability), their business plans and monitor their operations and activities after deciding to invest funds with them. It would certainly increase the cost of banking operations, more so during the initial period of PALSIB until devices are produced that would minimize the cost of screening, checks and inspections. However, this has also potential to increase the total returns of PALSIB banks. Furthermore, as banks will be involved in financing diverse businesses in different sectors of the economy as co-sponsors of projects or businesses, they will be in a better position to give valuable guidance to the funds users. This would reduce the chances of over investment in a particular sector or region of the economy.

PALSIB should be initiated in countries where the governments and central banks are fully supportive of the idea and ready to do whatever necessary to establish it. The top managers for PALSIB banks should be chosen from a pool of bankers who know the importance and complexity of the job and eager to offer best of their abilities. The next step would be to pick middle and lower level staff who are appropriately educated, intelligent and capable. They should be then trained extensively to work in the evaluation and monitoring departments of the banks.

The success of Grameen bank and its founder must be a reminder to all those who thought that banking without collateral was not possible. This bank has shown that if the staff is trained for a purpose and they are involved with the fund users, commercial banking is possible without collateral even when the borrowers are the poorest of the poor. If Islamic banks had done necessary home work and put required efforts, they could have shown the world that commercial banking is possible without involving interest.

5.2 *Dividend Markets*

The continued low levels of returns to depositors has also, at least partially, contributed to the growth of mutual funds that are increasingly providing comparative services with higher returns by investing in liquid assets such as readily tradable stocks and bonds. They never face a bank run situation as the depositors are never assured of their returns and they can always liquidate their assets to meet any demand of withdrawal. PALSIB is close to the concept of (non-money market) mutual funds.

Indeed, commercial banks are different from mutual funds and they do provide funds to many small producers to start new businesses or to expand their businesses. As they have to guarantee the principal and interest to their depositors, they cannot be allowed to invest beyond a limited amount in stocks and other risky assets. As PALSIB is based on the concept of non-guaranteeing a fixed and positive return to their funds providers, they would be well placed to invest a large fraction of their funds in stocks. While this may be seen as PLALSIB banks being involved in PLS mode of finance, too much exposure to stocks may keep the value of their assets and returns to their funds providers discouragingly unstable. This leads to another related issue in Islamic finance, the elimination of *mysir* (or gambling like transactions) in general and from the stock markets in particular.

It is often claimed that the current modus operandi of stocks markets creates an efficient and extremely liquid system. Any new information quickly adjusts the prices of stocks through continuous buying and selling of stocks. The system also allows liquidating one's position with ease and speed. The focus of participants, however, remains on making quick capital gains rather than earning through dividends. There is no denial that many of the best minds in the world try to gather and process information to make intelligent buying and selling of stocks. But I hope one should also admit that the system still creates such an immense level of speculative environment and drive to outsmart others that it hardly conform to Islamic teachings of patience and cooperation. One should also consider that stock markets are part of capital markets that are mainly responsible for financial intermediation. Stock markets, as secondary markets for shares, make the underlying asset attractive and thus facilitate initial sale of stocks that provides the resources needed for business expansion by growing companies. One can argue that a market of stock that makes the stock less liquid but reduces the amount of speculation and induce people to focus on dividend payments would be better suited for Muslim communities. I call it *dividend markets*.

The basic goal of *dividend markets* would remain the same as the conventional markets i.e., efficiently allocating the investible funds to the productive units of the economy. One of the requirements for listing in *dividend markets* could be that companies must not be violating any Islamic injunction including that they arrange all their financial needs through non-debt instruments. Establishment of PALSIB and *dividend markets* will thus help both of them in achieving their goals. Banks under PALSIB will be able to invest their funds in *dividend markets* earning regular income through dividend. The requirement that both PALSIB banks and companies listed at *dividend markets* only deal in profit and loss sharing transaction could also lead to devise a mechanism for even short term financing through profit and loss sharing methods.

The idea is to bring reforms in the current working of stock markets by making dividend payments the most important variable instead of capital gains. For example, one can argue what will be lost if people are allowed to trade shares only once a week or for that matter once in a month. Similarly, companies could be restricted in their decision about retained earnings, allowing most of the profits necessarily going every period to the share holders. Any new investment by a successful company could be attracted through new shares many of which could be sold to PALSIB banks.

5.3 Funds Providers, Central Banks and *Shari'ah* Boards

PALSIB banks should be asked to accept investment and non investment accounts. The non investment accounts would not pay any return and will require 100% reserve requirement. PALSIB banks could be allowed to charge a nominal fee for providing different kinds of banking facilities. The investment accounts on the other hand should not be subject to any reserve requirement but would not be allowed to invest more than what is provided by its original owners and investment accounts holders. The central bank should be the most important account holder of every PALSIB bank and must keep an active account providing necessary liquidity if needed for investment or meet demand for withdrawal. As a special account holder of the PALSIB banks, the central bank would closely watch the investment activities of these banks. The central bank would thus be able to control the supply of money without involving open market operations that involves interest.

Each central bank should constitute a National *Shari'ah* Board consisting of *Shari'ah* experts, Islamic economists, prominent ex-bankers, and contemporary financial experts from business and academia. This would enhance the quality of the judgments and avoid the perceived conflict of interests of the members. It will also lead to standardizing PALSIB products within a country.

The central bank should make sure that the activities and financial standing of PALSIB banks are transparent to a level that the conventional or other Islamic banks have never reached to. While the concerns of International Accounting Standard for banks and the compliance to BASEL II must be addressed, the central banks should come up with their own standard for accounting practices, accounts certification system and capital adequacy requirements based on the nature of their PALSIB products.

To create the right environment for PALSIB, central banks should be constitutionally asked to make price stability as their main responsibility and given necessary autonomy to achieve this goal.

5.3.1 Gradualism

It is important to realize that PALSIB cannot be established overnight. A lot of patience is required. However, things should not be left open ended. The PALSIB units at the central banks, top managers of PALSIB banks, *Shari'ah* Board members and other relevant government agencies should sit together to determine the speed of work in different aspects of PALSIB and come up with bench marks. The *Shari'ah* Boards should also be looking into the need to make changes such as operating rules of traditional *mudarabah* and other modes of financing. It has been often argued by Islamic bankers that they are handicapped by not having any control over the activities of *mudaribs*.

Rules of *mudarabah* could be changed to allow the *Rab-ul-Mal* to take part in the management, supervision and monitoring of a business. Similarly, with the help of the government, central banks must establish banking tribunals to make speedy resolutions of conflicts between PALSIB banks and their funds users.

5.4 Financing of Consumer Durables and Micro or Medium Size Loans

Commercial banks have been in the forefront for financing consumer loans specially that of automobiles and housing. Many of these loans are provided against expected stable stream of future income or collaterals and paid back in installments with accrued interest. First of all, there is no denial that such financing facilities do provide an important service to millions of people. However, if one accepts the notion that any amount of interest paid (that is over and above a compensation for inflation, in my opinion) is Islamically unacceptable, how would then the banks under PALSIB system continue to provide loans for consumer durables?

I propose that availability of reasonable funds for consumer durables should be available through government resources. We should keep in mind that under an Islamic system the commercial banks will not be allowed to create money and hence an added room for (non inflationary) money creation will be available to the government. A part of this resource plus an appropriate amount from government tax revenue could be channeled for financing consumer durables and housing. The management of these funds could be given to specially created government institutions for these purposes. Alternatively, these entities could be allowed to be established in the private sector who would receive the required funds from the government along with a reasonable percentage as fees for their services. An added advantage of this arrangement will be that, through proper guidelines given to these institutions, the government should be able to curb the rampant consumerism currently seen in many Muslim countries.

Micro financing is a relatively new phenomenon. Its founder, Dr. Younus has clearly shown the world that through an appropriate approach loans could be given to the poorest of the poor without involving collateral. The key to his success was the way bank employees engaged themselves with their funds users. Some people have criticized his organization for charging a high rate of interest. However, one has to see the motive of his organization which was to help as many poor as possible through a sustainable non profit organization (interest was not charged to make money but to cover the cost of operation and expand the *helping the poor* activity (not making money through interest). Indeed if the government could provide funds, there would be no need to charge any interest at all. Also an appropriate structure of profit and loss sharing arrangement could also be developed to finance such loans with proper training and organizational set up.

Works on similar line have to be done to cater the needs of small and medium size enterprises. With the level of advancement in information technology and improvement and innovation in forensic accounting, the supervision and monitoring of even small business are not as difficult as it used to be.

5.5 Cultivating a Reservoir of Islamic Entrepreneurs

Notwithstanding a possible objection to the term Islamic entrepreneurs, in my opinion, there is a need and opportunity to produce entrepreneurs that are properly trained and motivated to do business at different scales in an Islamically desirable way. Siddiqui

(2005) emphasizes the importance of entrepreneurs in general and for an Islamic economic and financial system in particular. Academic and professional training for different levels of managers should include all aspects of Islamic business ethics. Finally, the certification to do business could be awarded after taking a public oath to uphold the moral commitment required of them. After all, is it not the case that society expects a particular standard of morality from our doctors, teachers, preachers, etc., more than ordinary citizens? Entrepreneurship is vital for any economy; morally upright entrepreneurs could be produced through proper training and creating a high social status for them in the society.

6. Concluding Remarks

Although Islamic banking has grown substantially in terms of its number and levels of deposits, for many Muslims it does not appear to achieve anything significantly different from conventional banks. On the other hand, there are many Muslims who do not treat bank interest as *riba*, and point out that the current Islamic banking has also drifted from its ideals and pragmatism has made them inching towards more or less conventional banking.

A renewed effort has been made in this paper to show that bank interest does come under *riba* and interest is not inevitable for running a modern banking system. The paper also took issue with the current practices of Islamic banks who, after many years of operation, still heavily depend on *murabaha* and its variants. The paper gives a number of reasons for this and suggests that efforts be made for establishing a parallel profit and loss sharing Islamic banking (PALSIB) system.

It is suggested that there are fundamental difference between PALSIB and conventional banking that demands different approach and attitude by all the parties involved in its financial intermediation i.e., bank owners, fund providers, fund users and the government. A sufficient level of commitment and preparedness of all is a must for initiating a serious effort. After setting the right direction, assembling necessary human resources and establishing supporting institutions, gradual movements would be needed to reach the desired destination.

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