

Islamic Banking: True Modes of Financing

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Introduction

Prohibition of interest is ordained in Islam in all forms and intent. This Prohibition is strict, absolute and unambiguous. The Holy Qur'an in verse 278 of Surah Al- Baqarah states:

"O ye who believe! Fear Allah and give up what remains of your demand for riba, if ye are indeed believers." and verse 2: 279 says "If you do it not, take notice of war from Allah and His Messenger. But if ye turn back, ye shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly."

It therefore, follows that interest is prohibited as it leads to injustices (zulm) and

Islam is against all forms of injustices and exploitations and pleads an economic system, which aims at securing extensive socio-economic justice. The Islamic law of prohibition of riba, which includes interest, was originally not based on economic theory but on Divine Authority which considers the charging of interest as an act of injustice.

There could be no denying of the fact that under the interest-based system of banking or in a system not strictly based on the principles and spirit of Shari'ah, depositors as well as borrowers are exploited in one form or the other. It is however, significant to note that, as in the case of conventional banking, the depositors are being exploited most under the system and practices enforced by banks and financial institutions operating world-wide under the banner of Islamic banking.

Islamic banking made its debut over a quarter a century ago. At present 200 Islamic banks and financial institutions, operating in 27 Muslim and 16 non-Muslim countries, are managing a portfolio of about \$200 billion. It is now the time to pose the following questions:

- i. Whether banks operating under the banner of Islamic banking have succeeded in the elimination of injustices of the interest-based system as ordained by Holy Qur'an (2:279)?
- ii. Whether banks operating under the banner of Islamic banking have contributed to the attainment of socio-economic justice in line with the objectives of Islamic economic system?
- iii. Whether banks operating under the banner of Islamic banking are, for all practical purposes, not following the bench marks of

- interest-based system under Murabaha, Bai-Mu'ajjal or the like modes of financing?
- iv. Whether the net result in modes referred to at (iii) above really differs much from the interest-based loaning?
 - v. Whether by adopting the modes referred to at (iii) above, banks assume any responsibility for the operational losses of the party availing finances from them?
 - vi. Whether sharing in the operational losses are not the essence of Islamic system of banking?
 - vii. Whether large scale financing on a perpetual basis, on modes approved for "Sale transactions", can continue to be made for an indefinite period by Islamic banks which are not trading houses but are financial institutions?

While attempting to firm up views in respect of above questions, it must be kept in view that Islamisation of banking system is a part of overall Islamic value system and is not merely refraining from interest-based transactions. The objective of Islamic banking system is to make a positive contribution to the fulfilment of socioeconomic objectives of the society in all spheres, including trade, industry & agriculture etc.

True Modes of Financing

An Islamic bank is a financial institution which identifies itself with the spirit of

Shari'ah, as laid down by the Holy Qur'an and Sunnah, as regards its objectives, principles, practices and operations. An Islamic bank does not normally lend money except interest-free loans which are termed as Qard Hasanah (Benevolent

Loans) while loans on service charge, not exceeding the actual administrative cost of such loans, have also been permitted by Muslim Scholars.

To replace interest, the ideal mode of financing under the Islamic banking system is "Financing on Profit & Loss Sharing" (PLS) basis. Qard Hasanah is for the benefit of the individuals and the society at large. To safe-guard the interest of depositors/investors, these types of loans, as a matter of policy, do not constitute a significant source of financing by Islamic banks. However, if in any country, the Islamic System of Zakat is established and the Islamic State treasury starts functioning, the requirements of Qard Hasanah would primarily be met by the treasury.

The bulk of financing by Islamic banks has to be equity oriented. In this mode of financing, the losses are shared by the financier along with the entrepreneur in the ratio of their respective capitals. The profits are, however, shared in an agreed ratio. The rates of returns are thus replaced by ratios.

While designing an alternate to interest-based system, it was realised that large scale resorting to PLS system of Islamic banking could pose serious risks and hazards to Islamic banks due to wide-spread tendency to adopt un-ethical accounting practices to conceal true profits, high rate of illiteracy and host of other reasons.

It was therefore, considered necessary to devise various other modes of financing in addition to Mudaraba & Musharaka based on PLS system and of course, Qard-Hasan. These modes being the second line fixed return techniques include the following:

- i. Murabaha (Cost-plus sale).
- ii. Bay Mu'ajjal (Deferred payment sale).
- iii. Bay' Salam (Purchase with deferred delivery).
- iv. Bay' Istisna (Made to order).
- v. Ijara (Leasing).
- vi. Ju'ala (Loans with a service charge).

It may be mentioned that the above mentioned six modes cannot be expected either to remove the injustices of the interest-based system or to contribute to the achievement of socio-economic objectives which Islam seeks to achieve. The fact however, remains that these modes bear pre-determined fixed rates wherein neither the operational losses are shared by the banks nor the returns charged are dependent on the operational result of the entrepreneur.

It is important to note that Islam wants that in case the entrepreneurs earn profit from the finances provided to them by banks, these must be shared with the banks. The banks, on the other hand, must share their profit with their depositors /investors. A large number of depositors would thus hopefully be able to get significantly higher rates of return from the banks leading to over-all prosperity. It will be only then that justice would be ensured between the parties and the banks would start moving towards the path of making a positive contribution towards the achievement of socio-economic objectives.

Islamic banking is now over 25 years old. It is however, observed that, despite all the good intentions, Islamic banks world-wide have generally sheltered themselves in comfort zone by persisting with the second line fixed return techniques for bulk of their financing operations and that too within the benchmarks of interest-based system.

As the single largest mode of financing adopted by Islamic banks is on the basis of Murabaha, it is now proposed to briefly examine this mode.

Murabaha

Murabaha in ancient Islamic connotations referred to a particular kind of simple sale and had no relevance whatsoever with a transaction of financing. In view of

the difficulties and risks visualised in adopting PLS system of Islamic banking on a large scale, in recent times, the Murabaha, for all practical purposes was transformed from the sale transaction to a mode of financing.

In this mode, the bank, at the request of its client, purchases the specified goods from a third party against payment. Immediately on the transfer of ownership of the goods as also obtaining its physical or, in most cases, the constructive possession, the bank sells these goods to the client at cost plus an agreed fixed profit margin.

The client then takes physical possession of the goods and undertakes to pay the price to the bank either in instalments or in lump sum, at an agreed later date. The instances are not lacking where customers of the bank and the seller of the goods are sister concerns. In yet many other cases, the customers of the bank purchase the commodities themselves as agents of the bank and then they repurchase the same commodity from the bank for a cost plus profit to be paid at a mutually agreed later date. In many cases of Murabaha, there is therefore, only a change of name.

It is, however, felt that there would be no objection if an Islamic bank, in addition to its normal banking business, separately establishes a Merchant Banking Division wherein various types of goods are purchased and then offered for sale to other prospective buyers at a profit. There are however, serious reservations to the wide spread use of murabaha technique as a mode of finance where the bank purchases the commodity only after the customer has agreed in principle to purchase it from the bank at a profit - mark-up. It must therefore, be appreciated that under Murabaha, a trading transaction is being transformed into a mode of finance just to meet the Shari'ah requirements.

While referring to alternate modes of financing based on Murabaha and Ijara (Leasing) etc., Justice Taqi Usmani observes that if designed to fulfill the Shari'ah requirements, these modes can be adopted as transitory measure. He however, cautions that "... there should be a gap between purchasing the commodity and selling it to the customer and the risk of owning the commodity during the period should be borne with all its basic components and all its essential consequences."

In actual practice, practically there is no gap as in many cases, the bank makes the payment almost simultaneously or even after the goods are delivered at the premises of the client. The bank thus does not in fact assume any risk including even the risk of the goods, during the short period, the bank is

supposed to own and possess these goods. The bank however, gets a return at a pre-determined fixed rate, which is not dependent on the operational results of the entrepreneur.

This in any case, does not appear to be in conformity with the requirements of Shari'ah.

Taqi rightly observes: -

- a) Islamic banks are using the instrument of Murabaha and Ijarah within the framework of the conventional benchmarks like Libor etc. where the net result does not differ much from interest-based transactions.
- b) By not even gradually enhancing the financing on PLS basis, the basic philosophy of Islamic banking seems to be totally neglected by the Islamic banks.
- c) The Shari'ah Scholars have allowed the use of fixed return financing techniques i.e. Murabaha & leasing etc only in those spheres where Musharaka cannot work.
- d) When the common people realise that the net result in the transaction of the Islamic banks is the same as was in the transactions of conventional banks, they become sceptical towards the function of Islamic banks. It therefore, becomes very difficult to argue for the case of Islamic banking before the common people, especially before the non- Muslims who feel that it is nothing but a matter of twisting documents only.

Nijatullah Siddiqui says: -

"The payment obligations of the firms operating with murabaha - financed goods and services are independent of the profitability of the enterprise, unlike Profit Sharing, thus exposing it to the charge of being inequitable, as in the case of debt financing".

While commenting on "Mark-up" system he opines: -

"I would prefer that Bai' Mu'ajjal is removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form, we have the overriding legal maxim that anything leading to something prohibited stands prohibited. It will be advisable to apply this maxim to Bai'Mu'ajjal in order to save interest-free banking from being sabotaged from within."

At this point it is important to mention that Maududi observes: -

"Islam says in clear terms that the lender is not justified in earning a fixed rate of profit, irrespective of the operational results of the business."

It therefore, appears that, in most cases, the fixed returns charged by banks on transactions which are financial in nature are not permissible simply by providing them a cover of Murabaha or the like modes which are in fact transactions of sale.

It was over two decades ago that The Council of Islamic Ideology, Pakistan observed: -

"... ideally the real alternatives to interest under an Islamic economic system are profit/loss-sharing and Qard-Hasan."

While referring to other modes of financing such as Bai-Mu'ajjal, Hire Purchase & Leasing etc. the Council observed: -

"It is, therefore, imperative that the use of these methods should be kept to the minimum extent that may be unavoidably necessary under the given conditions and that their use as general techniques of financing must never be allowed."

The Council in this report cautioned:

"It would not be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back door for dealing on the basis of interest."

"The basis of this technique, though not prohibited according to Hanafi and Hanabali Schools of Fiqh and that too in exceptional circumstances, its wide spread use is not permissible as mark-up does not differ in essence from the interest system."

The Council however, observed: "It is unfortunate that this warning was disregarded and the mark up system was made the pivot of the new arrangements."

The Federal Shariat Court, Pakistan in its Judgement dated November 14, 1991 also referred to the following observations of the Council: -

"The fact of the matter is that "mark-up" is a crude trading practice which has been permitted by certain religious scholars under specified conditions. Its permissibility is questioned by other scholars. In any case, it is a device, which is relevant in the contract of transactions between a seller and buyer of goods. Banks are not trading organizations. They are essentially financial institutions which mobilise funds from the general public and make them available to productive undertakings."

Hasanuzzaman says:

“... the ghost of interest is haunting banks to calculate a fixed rate percent per annum in many modes of financing including Murabaha (Bai-Mu’ajjal, Mark-up) etc. The spirit behind all these contracts seems to make a sure earning comparable with prevalent rate of interest and as far as possible, avoid losses which otherwise could occur.”

He adds that "they (Second line techniques), have failed to do away with undesirable aspects of interest thereby they have retained what an Islamic bank should eliminate."

The Supreme Court of Pakistan (2000) in its' historic judgement delivered on December 23 1999 i.e. after about sixteen years of the observations, of The Council of Islamic Ideology, referred to above, inter-alia gave the following verdict: -

- a) "The major condition for the permissibility of a mark-up transaction is that it should not be charged on lending or advancing money. It must be based on the genuine sale of a commodity with all its substantive consequences."
- b) " ... Murabaha or Bai Mu'ajjal is a transaction of sale affected on the basis of deferred payment."
- c) "We are conscious of the fact that the transaction of a sale of murabaha based on mark-up, even after fulfilling its necessary conditions is not an ideal mode for the extensive use of Islamic banks, Still, the banks will have to resort to this transaction in certain cases, especially in the initial phase of transformation."

Looking at the Murabaha from yet another angle, it is important to note that Almighty Allah has condemned riba in harshest possible terms perhaps only second to "Shirk". It does not appeal to the mind that by simply assuming some risks by banks in financing through murabaha and the like during "shifting of stocks" from the godown of the seller to the entrepreneur (party availing finance from the bank) which can also be practically avoided and ensuring a fixed return on financing while not sharing in the operational losses of the entrepreneur, which is the essence of Islamic banking, the objectives of the Shari'ah are met.

It is obvious that the wide spread and persistent use of the second line techniques has neither contributed in removing the injustices of the interest-based system as ordained by Holy Qur'an (2:279) nor in securing the socio-economic justice in the society. If Islamic banks persist with these modes for bulk of their operations, the cause of Islamic banking would never be fulfilled.

It was only in the initial stages of transformation of the conventional banking system into Islamic banking system that the second line fixed return techniques could have been adopted by Islamic banks with a proviso that gradual shift to PLS system will take place. With the passage of time, the second line techniques should have been adopted only where PLS is not possible or feasible including say leasing of machinery or vehicle etc. which are not trading items of the enterprise availing funds from the banks. Unfortunately these modes have been allowed to be perpetuated by Islamic banks. This is injurious to the cause of Islamic banking.

During the last few years, a number of Western bankers, economists and journalists have posed to this writer a rather cynical question about what the real difference between the interest-based system and its Islamic counterpart, as being

Practised by Islamic banks actually is. However, even they concede that the PLS system of Islamic banking, if practiced in earnest, could ensure socio-economic justice across the globe.

It is therefore, seriously apprehended that if the present sad state of affairs is allowed to continue, even many innocent Muslims may develop doubts about the feasibility, practicability and usefulness of the "Islamic system of banking" notwithstanding that the fault lies with us and not with the system.

The large scale financing by banks on second line techniques is sometimes advocated on the ground that the size of Islamic banks is too small. The combined assets of 200 Islamic banks and financial institutions are almost 1/3 of the quantum of individual assets of some of the largest conventional banks. Since Islamic banks have to compete with these banks, they generally tend to avoid indulging in risky financing based on PLS. To make the situation worse, some of the Islamic banks find it more feasible to divert part of their funds received from Muslims to multinationals and large corporations of the West.

The Arab world including GCC countries and rich citizens of many others Muslim countries are reported to be maintaining huge deposits with conventional banks operating in the West. The quantum of these deposits is estimated to be more than the total external debt of Muslim countries.

The placement of these funds by Muslims is enabling the imperialistic powers to exploit the Islamic world by simply providing them loans and credits out of these deposits. The placement of funds in this manner by Muslims is clearly not in conformity with the directives of Qur'an and Sunnah.

The Ummah must keep in mind that according to the injunctions of Islam, surplus wealth of Muslims cannot be utilised for strengthening the Capitalistic System or for the benefit of non-believers or enemies of Islam. This wealth should therefore, be profitably invested for the common benefit of Ummah,

initially in their own country/region. The need of the hour is that a 'Fatwa' is issued on the subject immediately.

If only a portion of these funds is brought back to the respective Islamic countries, the size of many Islamic banks would become large enough to enable them to diversify their financing portfolio including more and more financing on PLS basis with greater sense of confidence.

Financing on PLS Basis

The real alternate to interest on loans in an Islamic framework is financing on PLS basis- a shift from debt based transaction to investment based funding. It is believed that the financing on PLS system of Islamic banking in a conducive environment would not only ensure a healthier financing portfolio and of course higher rates of return to depositors but would also lead to optimum allocation of resources for over-all economic growth and welfare of the society, individually and collectively.

It is however, accepted that the banks allowing financing on PLS basis are exposed to risk of losses as even a profitable company may sustain genuine loss due to various factors even beyond their control. The assuming of this risk is the essence of PLS mode of financing as all business transactions have an inseparable risk factor. It should not therefore, deter banks from making funds available on PLS basis to sound entities in feasible projects in the normal course of business.

In actual practice however, we find that traders and industrialists etc. generally earn substantial profit with the funds of a large number of depositors but they do not share these profits with the banks for onward passing on the share to the depositors. This injustice can be avoided if banks accept deposit on PLS basis according to its true spirit and also allow bulk of financing on the same basis. This will bring prosperity in the society, as a large number of depositors will be receiving higher rates of return on their deposits.

In the Islamic banking system, the concept is that of ratios in which profits and losses are shared instead of fixed, pre-determined interest and mark-up/profit rates. The issue of possible injustice due to inflation and recession, in money lending transactions, was settled by Islam over 1400 years ago, as PLS system absorbs the impact of inflation as regards the sharing of operational results are concerned. A glaring example is that of partnership where there is no dispute between partners due to high inflation or other-wise.

A comparison of the salient features of the financing on PLS Basis and the second line fixed return techniques are given below:-

Financing: PLS Vs Second Line Fixed Return Techniques

S. NO. Financing On PLS Basis Financing On Second Line Techniques

1. Unanimously held as an ideal mode of financing in an Islamic framework. A sale transaction which has recently been transformed as a second line mode of financing and that too for transitory period. Reservations are expressed by many scholars about these modes.
2. Inequitable distribution of income and wealth will be significantly removed. Inequitable distribution of income and wealth continues like interest-based system.
3. Depositors are likely to get higher returns leading to prosperity. Returns are practically based on the bench marks of the interest based system. Depositors continue to be exploited.
4. Justice between the parties is ensured as the return to the bank on finance is dependent on the operational results of the entrepreneur. Injustice of interest based system continues as bank is guaranteed a fixed return irrespective of the loss sustained by the entrepreneur. The return to bank is positive and predetermined in the shape of agreed price.
5. Inflation is likely to be controlled to some extent. Same as under the interest based system.
6. Progress towards Self-reliance will hopefully be made through enhanced rate of savings. Same as under the interest based system.
7. May lead to more efficient and optimum allocation of resources as compared to interest-based system. Same as under the interest based system.

It is now about the time that the performance of Islamic banks worldwide should be judged from the contribution it is making in achieving the objectives of Shari'ah in the real sense and not merely by the number of Islamic banks or the quantum of their deposits portfolio.

MODEL ISLAMIC BANK

It is important to appreciate that the requisites for total implementation and success of Islamic banking in a country, include re-shaping the society, re-structuring of the economic system and re-framing of the laws according to the dictates of Islam. The most important and difficult task however, is the reformation of society which has to be undertaken as an on-going process.

We therefore, need to change our priorities and at least as much emphasis should be laid on improving the ethics, honesty and values of the society as is being done for expansion of "riba-free banking". This will then create a conducive environment for more and more financing under profit and loss sharing system of Islamic banking.

Mirakhor observes, "Perhaps the most challenging issue facing the implementation of an Islamic financial system is the development of risk-bearing instruments that can provide the investors with a sufficient degree of liquidity, security and profitability to encourage their holding". Islamic banks also face a challenge of developing innovative services and products for utilising these funds effectively and efficiently for financing under PLS system.

In view of the position explained here-in-above and considering the real difficulties

in presently adopting the PLS system of Islamic banking for bulk of the financing for trade, industry and agriculture, it is felt that the need of the hour is to establish Model Islamic banks in all GCC countries as also in other Islamic countries where a large number of interest-free banks have been operating for a number of years.

The Proposed Model Bank would be a commercial bank. While the objective of the Bank would be to earn profit, it would identify itself with the Shari'ah as regards objectives, principles, practices and operations. The Proposed Bank would undertake all normal banking business as is done by interest-based banks but the

Provisions of Shari'ah would be kept in view at all times.

The proposed Model Bank would accept deposits/investments on PLS basis (other than demand deposits) and would also allow financing only on this basis. The operations of the Bank will be supervised from Shari'ah point of view by a board of religious scholars.

The proposed Bank would develop risk-bearing but competitive products for deposits / investments wherein depositors / investors are given reasonable assurance of higher returns as also of safety of their funds. This Bank would also develop innovative but competitive products for financing which are not only compatible with Shari'ah but also cater to the needs of traders and industrialists etc. in the modern complex world which is ever-changing.

The sponsor directors of the Proposed Model Bank should be Muslim Scholars, Jurists, chartered accountants, economists, bankers and investors. All these persons should be men of integrity and of highest reputation. They should also have unshakeable faith and commitment in the Islamic banking system and should have good knowledge of its principles, products and procedures.

These persons would take up the challenging assignment for the pleasure of Allah

and for proving that Islamic banking in its totality is not only workable but would Insha Allah also pay rich dividends in material terms to all those who deal with or work for the Bank.

It is sincerely believed that the proposal of Model Islamic Bank is not only feasible but is the need of the hour. The successful operational results of this Bank would also motivate the existing Islamic banks to enhance their share of financing on PLS basis.

Conclusion

The first full-fledged Islamic Bank was established in Dubai in 1975. In 1995, GCC countries accounted for 15 percent of the paid up capital, 27 percent of the assets, 34 percent of the deposits and 28.8 percent of the net profit of the Islamic banks world-wide. The Islamic banks in GCC countries are therefore, in an ideal position to take a lead to shift the bulk of financing operations to PLS system of Islamic banking.

It is now time that Islamic banks and financial institutions resolve to gradually enhance their share of financing on PLS basis and reduce the share of financing on the basis of Murabaha, Bai Mu'ajjal and the like modes of financing.

If Islamic banks succeed in demonstrating a practical example of socio-economic justice by gradually enhancing their financing on PLS basis and also achieve further satisfactory operational results, there is no reason why more cooperation would not be extended to them by the European, American and other interest based banks. Some of these conventional banks may even be tempted to adopt PLS system of financing in their subsidiaries & affiliates operating under the banner of Islamic banking.

The dawn of an era of justice can, therefore, be visualised where the fruits of the Islamic system would be available to a large number of people leading to over-all social and economic prosperity.