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Islamic Banking: A Study of the Relevant Operating Modes in Current Financial Scenario

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Abstract

Islamic Banking and finance has been an upbeat trend since 1963. It emerged within the sphere of Islamic economics and is guided by *Shari'ah* . The relevant themes of *Quran* and *Ahadith* were explored by Muslim jurists to search the possibilities for legitimate merchandise. *Fiqh al-Ma'amala,t* therefore, is the field that resulted in shaping of the Islamic Banking and finance. Till 1975 there were a few Islamic financial institutions especially in Egypt, Gulf States, and Malaysia governed by the Shariah Advisory Boards, but due to wider dimensions of the subject and deliberations of *Islamic Fiqh Academy* in 2nd Summit of OIC in Feb. 1988 at Jeddah, Saudi Arabia, a world-wide coerce of promoting *Riba* -free institutions became a solemn concern in Muslim States. Currently around 315 Islamic Banks are operating in some Muslim as well as Western countries. International Monetary Fund in 2005-09 calculated the growth of Islamic Equity institutions to set new standards for the commercial banking. The present paper attempts to study and highlight its character and relevance of the operating modes in the current financial scenario.

Keywords: - PLS scheme, Equity, *Shariah*, Partnership based contract

1. Introduction

Islamic banking and finance has been a hot debate since 1970's. It has been a decisive field explored by the Muslim scholars in the modern times. As an allied constituent of Islamic economics, the scholars wrote to develop this discipline since 1940. The Quranic term "*Ma'ieshah"* from which comes the word "*Ma'ashiyat*", is the recognized translation of the word "*Economics*" (20:124)[1]. The latest concentration towards *Islamic economics* occurred mainly due to altering world order and recession problems that alarmed interest-based financial mechanism around the globe. The Muslim nation states since 1950's had to face immense challenges as well as to set unsullied standards to attain and restore economic stability.[2] Islamic Finance, therefore, came up to explore and develop the economic aspect of Islam to build and facilitate a mechanism relevant to the exigent financial scnerio. The concept being to built a system divinely ordained, governing and enforcing accountability to stakeholders, moral behavior, fairness, equality, promotion of free trade and harnessing of resources through partnership as opposed to debt. The basic aims and objectives include:

1.1 Objectives

- To use the funds of surplus economic units to facilitate investment and asset allocation
- To facilitate trade and the commercial activities
- To provide financial services
- To create investment opportunities.

To attain the same, the economic and financial aspect of Islam was explored to relate it for the financial sector within the *Shari'ah* framework. The economic jurisprudence containing the guiding principles for the financial management supplied major themes to reorient researches in this direction. Consequently, by the regress effort of the Muslim scholars and financial experts, Islamic banking sector emerged in the West Asian gulf countries and South East Asia with the purpose to ensure banking activity within *Shariah*. Simultaneously, similar trends began in Pakistan, Indonesia and Malaysia during 1960's to reorient academic research in this direction. The objective being to initiate a system to fulfill the need of various stakeholders anxious to invest in the Islamic Banking sector. The system should also continue to perform the usual functions in its specified field as in the conventional system. The nature of the merchandise in Islamic banks will not be just the creditor-investor relationship rather a partnership-based contract (*'Aqd*) to share both profit and loss (*Mudharibah* and *Musharikah* scheme).In addition to the commercial bonds, the operating system must ensure growth of the weaker sections through equitable distribution of a variety of resources to attain the following :

2. Constructive Framework

1. Broad-based economic well-being with full employment and optimum rate of economic growth.
2. Stability in the value of money to enable the medium of exchange to be a reliable unit of account and a stable store of value.
3. A just return on investment and development projects.
4. Effective rendering of services expected in a standard banking system.
5. Equitable distribution of wealth and socio-economic justice.[3]

The four basic principles that govern the prospectus of the Islamic merchandise (banking) were considered as the primary conditions for investment which are:

2.1 Basic Principles

a. Guarantee of Interest-free transactions.[4](*La-Riba*)
b. Avoidance of commercial activities involving speculations.[5](*La-Gharar wa-la-Najsh*)
c. Utilization of *Zakat* for community welfare.[6] (*Zakat*)
d. Discouragement of goods and services forbidden under Islamic ideals.[7](*Haram*)

3. Earlier References

The earliest references to the reorganisation of banking system on the basis of PLS scheme were found in the works of Anwar Qureshi (1946), Naiem Siddiqi (1948) and Mahmud Ahmad (1952) in the late forties, followed by a more elaborate exposition by the writings of Mawlana Mawdudi (1950) - (1961), Muhammad Hamidullah 1944, 1955, 1957 and 1962 writings too should be included in this category. These writings recognised the need for Islamic commercial banks based on the concept of *Mudarabha* instead upon the cardinal principle of interest.[8]

Interest-free banking, in the coming decades, attracted more attention, partly due to the deliberations by Muslim financial experts in OIC summits as well as due to interest-based economies trying to re-colonise the world. The research works devoted to this subject began to appear and the first such work most probably is that of Muhammad Uzair (1955). Another set of works emerged in the late sixties and early seventies. Abdullah al-Araby (1967), Nejatullah Siddiqi (1961, 1969), al-Najjar (1971) and Baqir al-Sadr (1961, 1974) were the main contributors to accomplish the subject with superb academic standards. The convenient efforts were also made in Malaysia, U.A.E and Egypt to establish Islamic banks to identify such projects to study the subject with much relevant and wider dimensions.[9]

3.1 Institutional involvement

The institutional involvement began since 1970.The Conference *of the Finance Ministers of the Islamic Countries* held in Karachi in 1970, *The Egyptian study* in 1972,*First International Conference on Islamic Economics* in Mecca in 1976, *International Economic Conference* in London in 1977 were the result of such involvement. Meanwhile the initiative of some Muslim governments led to the application of theory to practice and resulted in the establishment of the first interest-free banks. The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process. The first private interest-free bank, the Dubai Islamic Bank, was also set up in 1975 by a group of Muslim businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt and the Sudan. In the same year the Kuwaiti government set up the Kuwait Finance House an alternate provision to carry investment provisions on PLS basis.[10]

However, small scale limited scope interest-free banks have been tried before in Malaysia and Pakistan. In 1962 the Malaysian government set up the "*Pilgrim's Management Fund*" to help prospective pilgrims to save and profit. The savings bank established in 1963 at Mit-Ghamr in Egypt was very popular and prospered initially and then closed down for the financial security reasons. However this experiment led to the creation of the Nasser Social Bank in 1972. In the ten years since the establishment of the first private commercial bank in Dubai, more than 50 interest-free banks have come into being. Though nearly all of them are in Muslim countries, there are some in Western Europe as well: in Denmark, Luxembourg, Switzerland and the UK.The Islamic equity based banking became popular by 1983 and increased considerably in the following years.[11]

3.2 Researches and Conferences

The researches and conferences explored Islamic finance and banking sector set new standards since 1984. Hence forth, the provisions of interest-free banking and evaluation of their performance and share was studied.[12] This evaluation focused for the rediscovery and expansion of equity based techniques mentioned in the juristic literature. The titles of the research projects bear testimony to this and indicate the world-wide interest in the subject. *Conference on Islamic Banking: Its impact on world financial and commercial practices* held in London in September 1984, Workshop on *Industrial Financing Activities of Islamic Banks* held in Vienna in June 1986, *International Conference on Islamic Banking* held in Tehran in June 1986, *International Conference on Islamic Banking and Finance: Current issues and future prospects* held in Washington, D.C. in September 1986, *Islamic Banking Conference* held in Geneva in October 1986, and *Conference 'Into the 1990's with Islamic Banking*' held in London in 1988 and The Workshop on the *Elimination of Riba from the Economy* held in Islamabad in April 1992 belong to this category. Special mention must be made of the work by M. Akram Khan in preparing annotated bibliographies of all published and some unpublished works on Islamic Economics (including Islamic Banking) from 1940 and before. It is very useful to students of Islamic Economics and Banking, especially since both English and Urdu works are included (1983, 1991, 1992). M.N. Siddiqi's bibliographies include early works in Arabic, English and Urdu (1980, 1988). Turkish literature is found in Sabahuddin Zaim (1980).[13]

4. The Nature of Current Operating modes

Islamic banking has come up from its teething stage and is now in 38th year since its inception and is growing at a rate of 10-15% (2005-2009) and with signs of consistent future growth Islamic banks have more than 300 institutions spread over 51 countries, including the United States through companies such as the Michigan-based University bank, as well as an additional 250 mutual funds that comply with *Shariah* standards. The operating modes, in Islamic banking are identified with *la riba* (No usury) verdict which is absolute and unambiguous:

"O ye who believe! Fear Allah and give up what remains of your demand for *Riba*, if ye are indeed believers." (2:278)

The Quran again:

> "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." (2:279)

It therefore follows that *Riba* (Usury) is prohibited as it leads to economic injustice. Islam pleads a system that aims at securing extensive socio-economic justice along the sustainable growth. The Quranic verdict of the prohibition of *Riba* considers the charging of interest as an act of injustice; hence the operating modes of Islamic banking abstain from such transactions that involve such impure components. The depositors and Investors share the returns on pre-determined ratio instead of interest .[15]

4.1 Diagnosis

While discussing the progress of Islamic banking one has to assess:

i. Whether Islamic banking has succeeded in the elimination of injustices of the interest-based system as ordained by Holy Qur'an (2:279)?
ii. Whether Islamic banking has contributed to the attainment of socio-economic justice in line with the objectives of Islamic economic system?
iii. What is the current scenario of the Islamic financial institutions around the globe?

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 fulfillment of economic growth and sustainable development of the society. [17]

An Islamic bank, is a financial institution that identifies itself with the spirit of *Shari'ah*, The *Fiqh al-Maamalat* (economic/financial jurisprudence) discussed and explored in the juristic literature, public good (*Istehsan*) and *Maqasid al-Shariah* are some of the identical factors that determine the course of operations in these institutions. 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 jurists. To replace interest and its possibilities in finance, the ideal mode of financing under the Islamic banking system is *Mudharabah* "*Financing on Profit & Loss Sharing*" (PLS) basis that makes the depositors share holders. [18] *Qard Hasanah,* therefore is for the benefit of the weaker sections of the society at large. To safe-guard the interest of depositors/investors, these provisions and 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 mandated to the Islamic banks, the requirements of *Qard Hasanah* would primarily utilized for the weaker sections of the society.[19]

The immensity of financing by Islamic banks has to be equity based. In this mechanism, 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 in this system are thus replaced by ratios.[20] The Islamic financial experts, while designing an alternate to the existing interest-based system, realized that large scale resorting to PLS system of Islamic banking could pose serious risks and hazards to Islamic banks due to high growth of the conventional banking system. It is therefore, considered necessary to devise various other modes of financing in addition to *Mudaraba* & *Musharaka* based on PLS system and *Qard-Hasan*. These modes being the second line fixed return techniques include:

4.2 Financial Techniques

i. *Murabaha* (Cost-plus sale).
ii. *Bayah Mu'ajjal* (Deferred payment sale).
iii. *Bay'ah Salam* (Purchase with deferred delivery).
iv. *Bay'ah Istisna* (Made to order).
v. *Ijara* (Leasing).
vi. Ju*'ala* (Loans with a service charge).[21]

The implementation of the above stated modes can be expected to remove the injustices and can be a well start to contribute to the achievement of socio-economic growth 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.[22] It becomes imperative to note that Islamic financial system 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 instead of ensuring the minimal returns whatsoever. 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[23].

5. Relevance of *Murabaha* Contract *(*Cost-plus sale)

Bai'ah Murabaha as a financial contract in juristic connotations of Islam is referred to a particular kind of simple sale where profit over the actual cost is guaranteed.[24]. In view of the difficulties and risks visualized 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.[25]
In this mode, the bank, at the request of its client, purchases the specified goods from a third party against Payment.[26] 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.[27] The client then takes physical possession of the goods and undertakes to pay the price to the bank either in installments 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.[28] 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.[29] While referring to alternate modes of financing based on *Murabaha* and *Ijara* (Leasing) the eminent scholar 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''.[30]

In actual practice, 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.[31]

6. Contemporary Debate and Deliberations

The contemporary scholars have the following observations with regard to the financial operations:

Justice Taqi Usmani observes: -

a) Islamic banks are using the instrument of *Murabaha* and *Ijarah* within the framework of the conventional benchmarks 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 *Murabaha* & leasing etc only in those spheres where *Musharaka* cannot work.

d) When the common people realize that the net result in the transaction of the Islamic banks is the same as was in the transactions of conventional banks, they become skeptical 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.[32]

Dr.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".[33]

While commenting on "Mark-up" system Dr.Nejatullah Sidiqui 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".[34]

In Islamic jurisprudence 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 in 1980 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*".[35]

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".[36]

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".[37]

Hassanuzaman 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".[38]
> Simultaneously he adds "they (Second line techniques), have failed to do away with undesirable aspects of interest thereby they have retained what an Islamic bank should eliminate."[39]

The Supreme Court of Pakistan (2000) in its' historic judgment 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.[40]"

b) " ... *Murabaha* or *Bai Mu'ajjal* is a transaction of sale affected on the basis of deferred payment.[41]"

c) "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".[42]

6.1 Current Scenario

It was only in the initial stages of transformation of the conventional banking into the Islamic banking system that the second line fixed return techniques could have been adopted by Islamic banks with a provision that gradual shift to PLS system will take place.[43] 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, vehicle or any other commodity of the routine use. Unfortunately these modes have been allowed to be perpetuated by the Islamic banks. This is injurious to the cause of Islamic banking. However, the PLS scheme of Islamic banking, if practiced in letter and spirit, could ensure socio-economic justice as well as the chances of growth for the Muslim minorities across the globe.[44] Islamic banks have to compete with conventional 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.[45]

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.[46] The quantum of these deposits is estimated to be more than the total external debt of Muslim countries. Therefore, 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.[47]

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.[48] 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.[49]

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.[50]

Practically, however, we find that traders and industrialists 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.[51] Islamic banks face a mighty challenge of developing innovative services and products for utilizing these funds effectively and efficiently for financing under PLS system.

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