A contemplation on the Concept of Islamic Banking

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Introduction.

Islamic banks are now major players in world finance. They are banks but they are truly unique. The Islamic banking model had attracted the attention of the leading Financial Institutions world wide, because it presents a "different" form of final intermediation.

Twenty years after the emergence of the first Islamic bank, one need not call the attention of the reader to how an Islamic bank operates. In fact, terms like Murabaha, Mudarabah...etc. are quite familiar in financial circles and widely known even to non bankers.

However, the growth of Islamic banking and the ability of the Islamic banking model to expand will not come by without an articulation of the "Concept" of Islamic banking.

It would be very simplistic to just assume that Islamic banking is, merely interest free financial Intermediation. What we need is an abstraction of the model of Islamic banking and the *Sharia* constraints and bounds of financial in a way that may lead to a theory that can serve as a foundation for financial innovation.

Prologue:

Human societies, with no exception, consist of two groups of individuals, those who have more resources than they directly need, and those who need more resources now than they immediately own. Because membership in each group is not constant (but mobile), it was not difficult to see that the welfare of every one will be improved if an arrangement is devised through which resources are transferred from one group to another on a continuos basis. The annals of ancient history are full of exemplification's of such arrangements,[1] which we may, loosely call, financial intermediation.

The emergence of banks was an annovation in the form, but by no means an invention of financial intermediation.

Although some historian claim that the institution of banking was known to the Europeans as far back as the time of the Greeks, banking was only introduced to the Islamic world (by the European) during colonialism. It is no accident, therefore, that the emergence of the idea of Islamic banking coincides with the era of independence of Islamic countries from the direct role of the west. Why Muslims rejected conventional banking is quite obvious. It is puzzling, however why didn't Muslims know any form of banking of their own. Through Islamic civilization was tolerant enough to embrace a lot of ideas and institutions from non Islamic cultures, yet, no evidence at our hands that banks did exist in medieval Muslim societies.[1] This is more surprising when we realize that commerce was the most important economic activity in many parts of the world of Islam.

The answer is rather straight forward. Muslims had their own arrangement for financial intermediation. We quote one prominent historian of medieval Islam.

"The entire reservoir of monetary resources of the medieval Islamic world was mobilized through these two methods [Mudarabah and Musharakah] to bring together investors and managers for the purpose of supporting crafts and manufacture and expanding by distance trade"[1]

It is because of this the modern Islamic banking was based on the idea of Mudarabah,[2] and was infact_______for

The "bondage" of Mudarabah.

Ever since Uzair[1] wrote what may be the first articulation of what an Islamic bank should be like, the minds of the students of Islamic finance was fixed on this ideal of profit and loss sharing banking system. It was thought that an Islamic banking is basically a two tier Mudarabah. The cherished outcome of equitable distribution of income, stability and full employment can only be attained if the model of Islamic banking is based on the idea of Mudarabah. It is because of this, Murabaha let alone sale of debt, is looked at by many, as an anomaly and considered to be only a temporary phase. The calls to "correct" Islamic banking back to Mudarabah are now familiar ones.[3] The superiority of profit and loss sharing in financial arrangement is not disputed, nor the positive effects of Mudarabah are doubted. The problem however, is that we, by insisting on a Mudarabah based model of banking, are actually Imbedding the possibilities of growth and the potential for innovation and change. This is simply because, firstly; by confining ourselves to Mudarabah we are actually setting too high a standard for Islamic banks. A standard that is practically infeasible. Experience show that Mudarabah arrangements is throttled with "moral hazard".[1] Secondly, by theorizing that all the "goodies" of an Islamic Economic System (equitable distribution of income ....etc). will come out of Islamic banking, we reduce the whole Islamic system with all its social, political and educational components into one institution. The result will naturally be, great disappointments.

Why do we need a new perspective on the Concept of Islamic banking?

That Mudarabah as a financial arrangement is superior to other forms of finance is beyond doubt.

A Mudarabah based model of banking is, unfortunately, too narrow to allow any significant progress or prompt any effective change. Even a casual observer of Islamic banking will see that recent developments are taking a course away from Mudarabah and in the direction of fixed return types of financing. We believe that a new perspective on the concept of Islamic banking is needed at this juncture for the following reasons:

a) The fact that Murabaha is now the core of the asset side of Islamic banking and not profit & loss sharing the relationship between most Islamic banks and their users of funds is very much a borrower-lender relationships. Arguing that the concept of Islamic banking is based on Mudarabah clearly means that our contemporary Islamic banking system is irrelevant.

b) Limiting our analysis of the model of Islamic banking to Mudarabah is, in my view, without justification. *Sharia* rules of financial transaction can accommodate a broad assortment of contractual relationships. Our efforts should be directed towards building a solid and efficient banking system based on all the *Sharia* permissible financial relationships and not only Mudarabah. Otherwise, we will be sort of second guessing the wisdom of the various “halal” modes of finance.

c) facing an “awesome” degree of competition from conventional banking in and outside Muslim countries, Islamic banking have no hope of survival, let alone growth and progress unless it succeeds in innovation. Without the ability to respond to the needs of the individuals and the change in the environment (economic, otherwise) Islamic banking will soon become obsolete.

d) Broading our prospective of Islamic banking will widen the vision of *Sharia* scholars and facilitate their inference and opinions that can help in innovation.

<u>A Contemplation on the Concept of Islamic banking:</u>

We submit that the concept of Islamic banking which appears to be overlooked by the students of Islamic banking is based on a simple but a very powerful idea. Islamic bank is an institution that eliminates the divorce between the real sector and the financial sector in the economy and functions in such a way that it don't produce an independent "money" sector.

In a conventional economy the financial section is detached from the real sector. In the former, agents deal in financial product that are designed to allocate credit risks and predetermined rewards and infact make money out of money in the latter *entrepreneurs* joint labor, land, capital and management to produce real goods and services. When a break-up between the two sectors takes place, this means that money becomes a "commodity" by itself. one can generate more money[2] without ever needing to produce any "real" good or service. This will result in serious consequences:

a) Severe booms and busts, because each sector has its own dynamics, a *decrease* in demand for real goods which *causes* a reduction in the profits of producers in the sector, will have a *devastating* effect because the obligations to the financial sector will not be effected by the reduced profit. This means that an economy will not be able to get out of recession without government intervention.

b) Inequitable increase distribution, return on investment of the agents in the financial sector can only come from the profit generated in the real sector.[1] Yet it is "contractually" independent of it this means that the process of financial intermediation also work to re-distribute income between imaginary groups: risk averse and risk takers. risk averse are those who want to take credit risks, and risk takers who want to carry commercial and other risks.

The function of an Islamic bank is to pool all the risks together. This means the elimination of *dichotomy* between the real and financial sector.

This means a new concept of Islamic banking is needed. One that doesn't confine the model to Mudarabah, but broaden the prospective to include this basic idea. We may suggest that an Islamic bank is a financial intermediary that تلحم the real and the financial sector. This can be done by making sure that any monetary transaction reflects and is related directly to a real transaction. This includes Mudarabah and Musharakah but it is not confined to it. It infact includes every permissible transaction and contract.

<u>The evidence</u>

While this basic idea does stand on its own merits, one can derive the same conclusion by looking through the rules of *Sharia*. In the following we are presenting an example to give some insights on the idea being contemplated.

a) It is a forgone conclusion in Islamic *Sharia*[1] that money is medium of exchange that facilitate commerce and other transactions, but it can't be, by itself, an object for commerce. A financial sector can't be created in an economic system which abides by this constraint.

b) It is permitted in *Sharia* to sell on deferred payment. it is also permitted to increase the price on deferred payment sales. However, it is not allowed to increase debt obligations in the case of delinquency or default to compensate for time. The logic is that in the first place monetary transaction is reflected in the exchange of a good or a service. In the second place, if this is allowed it becomes a purely monetary one because the objection of the transactions is the outstanding obligation (debt).

c) In Sharia, a debt obligation (receivable) can't be sold. But there is no objection to transferring the debt to another agent, through sale of debt(at a profit) not for a monetary price but for a "commodity" compensation. It is even permitted to profit out of this transaction. Further more, many Fugaha (Particularly Maliki's) allow sale of goods bought on Salam basis before acquisition. These goods are clearly "debt". But it is debt in kind and not a monetary one.

This show, that there is a clear purpose for this particular *Sharia* rule. That pure financial transaction are to be avoided. Financial obligation(which includes debt & money) can be exchanged only for real good, services.

d) It is the Ijma (consensus's) of all Fugaha (of every school of Figh) that receiving monetary payment for granting Dhaman (guarantee of outstanding debt) is not permitted. It has always been very puzzling, because *Sharia* does encourage individuals to grant Dhaman to their fellow Muslims who needed. The explanation, it appears, are in line with our contention. Permitting monetary resumiration for guarantee creates a "niche" of pure monetary transactions. This happens when the guaranteed person fails to pay to the beneficiary, and obligation falls on the back of the guarantor. The latter will then go after the First Party to make the payment. When this is done, the guarantor will be, imbalance, receiving more than what he actually paid, making it a profitable venture for him, but one of pure financial nature.

e) It is occasionally claimed by some writers that *Sharia* don't recognize the "time value of money". Their ground is the fact that interest is not permissible. The fact is *Sharia* does recognize the time value of money in all transaction and allows for taking that into consideration, either in Murabaha bai mujjal, Salam, Istisna'a, ...etc. It is only when allowing such leads to pure monetary transaction and the creation of a separate financial sector that *Sharia* prohibits. This is the case of lender-borrower relationship. Even in such cases, (like in qard-hassan) *Sharia* recognizes the time value of money but requests Muslims to forgo that for greater reward in the hereafter. It has been narrated from the prophet (PBUH), that reward for quard-hassan is even more than that of "Sadagah".

f) It has been narrated from Ibn Abbas: when some one assigns another as agent for sale of goods assured by the former and is told: if you get me $ 100 for each item, you can sell at any price and take the extra for yourself. Ibn Abbas said, this is permitted if you sell cash, If you sell on deferred payment it is not allowed.

The logic is straight forward. if you sell cash payment for say $ 150, and you get $ 50, then this is your agency fee. But if the sale was on a deferred payment then your $ 50 is a compensation for the credit extended by you (agent) since you are not the actual seller, (i.e. the increase is not part of the sale contract). Ibn Abbas's penetrating eye was able to see that if this is allowed, then a "cottage industry" may be created around this pattern of trade which is of pure monetary nature.

<u>What does all this mean?</u>

If we accept the proposal that an Islamic bank is actually a financial Intermediary where function is to bridge the gap between the financial and real sectors in the economy, making sure that every use of cash or monetary obligation is not separated from actual production and exchange of real goods and services. An agenda for Islamic banking innovation comes out of this for example:

A) Not only that Murabaha is fine and welcome, we should go one step further in eliminating the current complicated procedures. Can we say that it is more important in Murabaha to make sure that when money exchange, hands there is a good or service being exchanged, than to bother with counter ____and shady documentation.

B) We shall work very hard to design modes for *secritization* of debt. Due to our fixation on Mudarabah, we concentrated our efforts into trying to take Islamic banking away from fixed return finance into profit sharing. We had no time to deal with debt and receivables because they are always assured to be "an anomaly" ignoring the fact that debt constitutes, for some Islamic banks, upto 90% of their assets. With this concept, however, we have some "hint" to lead our innovation effort into designing methods that are acceptable from *Sharia* point of view and capable of allowing growth even in a Islamic banking that is mostly Murabaha based.

C) With this proposed concept, we have to broaden our thinking about Mudarabah it self. Can we say that whenever there is a profit generating activity then Mudarabah is possible? If this can be accepted then a solution to a formidable problem facing Islamic banking can be found. This is the problem of very short term credit (regular overdraft). Statistic show that this is the kind of credit no business can do without. yet, there is no arrangement in the “menu” of Islamic banking to satisfy this need if is serves the objective of *Sharia* to make sure they money advanced through Mudarabah is used for production of real goods and services, and profit is actually generated from such activity, Mudarabah then becomes a very strong tool in the hands of Islamic banks. Credit can be extended on basis of Mudarabah, earning the average of the overall profit at the end of the year of that company on a daily basis.