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FINAL PAPER

"Reform in Finance: *Riba* vs. Interest in the Modern Economy'

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Abstract

Muslim scholars generally equate *riba* with interest. They fail to see a vital distinction that needs to be drawn between *riba* declared forbidden in the Quran and interest that has come to play a necessary and very useful role in modern finance and economic policymaking. As some modernist scholars, notably Fazlur Rahman, have shown, interest used in modern finance is substantively different from *riba* and works like any other economic price. I also argue that *riba* forbidden in the Quran applies only for those who deserve humanitarian treatment – who need concessional or interest-free loans (*qard-hasana*) or outright grants (*sadaqa*). Thus though there is no epistemological ground to think that receiving and paying interest in modern financial transactions is a forbidden thing, Islamic finance institutions are based on the very notion that interest is taboo. However, these institutions are found to have largely failed to get rid of interest, in part, because the interest-free principle is hard to realistically apply except in equity (as in *mudaraba* and *musharaka*) financing, which is only marginally used by these institutions due to difficulties and risks involved in such financing and, also in part, because just equity financing does not work for a stable banking industry.

I. INTRODUCTION

The label "Islamic" used with Islamic finance and banking institutions is inapt, not simply because interest used in modern finance cannot really be condemned as unIslamic, but also because the very principle which justifies their existence in the first place, namely that they

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should do away with interest, is found, on scrutiny, to be largely violated in practice. The purpose of this paper is thus two-fold: first, to highlight the point that interest used in modern finance is a legitimate economic price and second, to suggest that Islamic banks have not been able to avoid interest except only marginally. We cover the first point in the next section. This is followed, in Section III, by a discussion of the major investment products that the Islamic finance institutions offer and of how they fail for the most part to go without interest. Some conclusions are offered at the end.

II. IS INTEREST USED IN MODERN FINANCE REALLY BANNED IN ISLAM?[1]

Muslim jurists have widely differed on the specific meanings attached to *riba*, "which is often, although inaccurately, translated as interest."[2] "*Riba*" literally means "an increase," but all increases are not *riba*. Despite numerous differences of opinions among pre-modern jurists about the rules of *riba* restrictions, modern Muslim scholars generally equate *riba* with interest. This explains the existence of so-called Islamic finance, which seeks to do away with paying and receiving interest. However, as we will see, this view of interest is grossly mistaken. Interest, as distinguished from *riba*, has come to play a vitally important role in the modern economy.

It is appropriate to concentrate on the meaning of *riba* that the Quran appears to convey. We need to closely examine the Quranic hermeneutics and epistemological reason for the ban on *riba*. The position generally taken by Muslim scholars does not appear to be really tenable on epistemological grounds. On close scrutiny, we can see that the apparent reason for the Quranic injunction on *riba* stems out of a social concern for establishing justice and fairness to the borrowers who were burdened with unbearable debt because of the extortionate nature of the *riba* that used to double and redouble on non-repayments, as mentioned in 3:130. This was a pre-Islamic Arab practice, which obviously needed to be condemned on equity or humanitarian grounds. Because of the extortionate (usurious) way Arabian lenders used to lend money, the Quran warns the lenders, in 2:278-280, to give up the remainder of any *riba* payments due from the borrowers, to be content with just capital repayments, and to postpone repayments or, better still, to write off the loan by way of *sadaqa*, if the borrower is found to be in a financially straitened condition. This *riba* prohibition then is clearly based on equity, justice, or humanitarian considerations. This *riba* should not be equated with interest that has come to be used in modern finance and which represents the opportunity cost of capital. A number of Muslim scholars distinguish between *riba* forbidden in the Quran and interest used in modern finance, contending that while the former is clearly unethical and unacceptable, the latter is a legitimate economic charge.

The Dissenting Views of Earlier Scholars

Some earlier Muslim scholars who expressed the dissenting view that *riba* was not interest and rejected the ban on interest include the thirteenth century Muslim scholar Izz al-Din Ibn 'Abd al-Salam al-Sulami (mentioned by Fazlur Rahman[3]) and early twentieth century reformist thinker Rashid Rida. Al-Sulami "rejected the ban on interest that had been almost unanimously pronounced by Muslim lawyers, as he rejected stoning to death as punishment

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[1] This section closely follows a chapter of the author's book *Exploring Islam in a New Light: A View from the Quranic Perspective*, Brainbow Press, 2010. Some of these points were repeated in his article "Is Interest Really Banned in Islam," Aslan Media, July 4, 2012; available at http://www.aslanmedia.com/arts-culture/mideast-culture/6491-is-interest-really-banned-in-islam.

[2] See, for example, a detailed survey on the subject by Mohammad H. Fadel, "*Riba*, Efficiency, and Prudential Regulation: Preliminary Thoughts," *Wisconsin International Law Journal*, Vol. 25, No. 4, August 2008 at http://hosted.law.wisc.edu/wordpress/wilj/files/2012/02/fadel.pdf.

[3] Rahman, Fazlur, *Islam & Modernity: Transformation of an Intellectual Tradition*, University of Chicago Press, Chicago, London, Paperback Edition, 1984 (Original 1982), p. 30.

for adultery and roundly declared the entire traditional material on the issue to be utterly unreliable."[4] Rashid Rida rejected the claim that an interest-bearing loan from its inception was forbidden. "Responding to a series of questions presented to him regarding *riba* in 1907, Rida concluded that the rules of the riba of excess are entirely prophylactic, and the only kind of *riba* that is morally condemned by the Qur'an is the *riba* of the pre-Islamic era."[5] He argued, "The only reason people trade is to obtain 'an increase, either in quantity or quality, and neither is prohibited for its own sake, since obtaining a gain is the very . . . goal of commerce.'[6] Since that is the case, the prohibitions of the *riba* of excess can be overridden whenever there is a legitimate need to do so."[7]

Fazlur Rahman's Contribution

It is the noted Pakistani-American scholar late Fazlur Rahman who has provided a fuller articulation of the modern dissenting view on interest. In a groundbreaking article written in Urdu in 1963 and translated in 1964,[8] he cites some sources and observes that, in the pre-Islamic Arabian practice, the initial payment of interest itself for a certain period of time "was not usurious and was, therefore, not considered *riba*. What made it *riba* was the increase in capital that raised the principal several-fold by continued redoubling. […] [I]n case the debtor was unable to pay, the term of payment was extended with an enormous increase in the principal amount."[9] He further argues, "When the entire system was banned, the milder cases within that system were also naturally abolished since the system itself was tyrannical. It cannot, therefore, be argued that since the Qur'an abolished even the milder cases, it must be concluded that the bank-interest of today also stands condemned; this is because the bank-interest of today is a separate kind of system."[10] He aptly argues that in the modern economic system, "interest occupies the same place as price and performs the all-important function that any price-mechanism performs, viz., of regulating the supply and demand of credit and rationing it among the customers. If the rate of interest, i.e., the price of loaning money, is reduced to zero, then we are faced with a limited supply and an infinite demand. It would become impossible to control the rationing of credit available, so to say, and to assign priorities."[11] According to him, *riba* is forbidden in the Quran precisely because, in that historical context, it was indeed exploitative, doubling and redoubling at times of non-repayment. He criticizes Abu Ala Mawdudi's contention that interest is simply a matter of haggling and speculation on the part of the lender and the borrower. According to him, Mawdudi's position betrays his lack of knowledge about how modern finance works. He

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[4] *Ibid*.
[5] Fadel, Mohammad H., *op. cit*., p. 680.
[6] FATAWA AL-IMAM MUHAMMAD RASHID RIDA , supra note 126, at 607-08, cited in Fadel, Mohammad H., *op. cit*., p. 681.
[7] Fadel, Mohammad H., *op. cit*., p. 680.
[8] Rahman, Fazlur, "Riba and Interest," *Islamic Studies* (Karachi), 3(1), March 1964, pp. 1-43 (the original article titled "Tahqiq-i Riba" is published in Urdu in the journal *Fikr-o Nazar*, i/5, 1963, translation by Mazheruddin Siddiqi) available at http://www.globalwebpost.com/farooqm/study_res/i_econ_fin/frahman_riba.pdf.
[9] *Ibid*.
[10] *Ibid*.
[11] *Ibid*.

rightly points out, as modern economists do, that interest used in modern finance depends on "many complex economic factors."[12] But he did not analyze these factors.

He also speaks of a co-operative welfare or *sadaqa* system, which can rule out the use of interest. He maintains that until that welfare state can be achieved, going without interest will be suicidal for a modern economy. Fazlur Rahman's idea of a welfare system is somewhat parallel, but not exactly similar, to the idea of a stationary state that economists sometimes talk about. In the stationary state, which is characterized by no net investment (any new or gross investment that takes place just replaces existing depreciated capital), there is no need for interest to arise. But our real world is far from reaching that state.

Position of Other Modern Scholars

Several other modern scholars associate themselves with the distinction between *riba* and interest. Imad-ad-Dean Ahmad of the Minaret of Freedom Institute cites people's time preference – the fact that goods and money are valued by people more at present time than at a future date – as the cause for interest to arise and argues that any unconscionable overcharging, whether on an interest rate or on a spot price, is *riba*, but market interest is not *riba*.[13] Yusuf Ali, in a commentary in his most popular Quran translation, says, "My definition [of *riba*] would include profiteering of all kinds, but exclude economic credit, the creature of modern banking and finance."[14] Muhammad Asad, Muhammad Pickthall, M. H. Shakir, and Edip Yuksel and his colleagues also translate "*riba*" as "usury" in an excessive sense, meaning that interest used in business transactions in the structure of modern credit and banking does not qualify as *riba*. Other scholars who also align themselves with this modern view of interest include author Imam Feisal Abdul Rauf and the Turkish author and columnist Mustafa Akyol. Rauf rightly points out that the invention and use of interest was one of the pillars of capitalism, which, together with the development of limited liability corporate businesses and the growth of liberalism, was instrumental in dramatically changing the economic fortunes of the Western world, while the Muslim world lagged far behind. "The strict prohibition on charging interest still prevails in the Muslim world and has largely prevented it from robustly developing the financial market's institutions of banking, capital markets, and stock exchanges, the foundations of capitalism. Neither could the Muslim nations effectively control their own monetary policies, since raising and lowering interest rates is the chief way a nation's central bank controls inflation and the amount of money in circulation."[15] Mustafa Akyol thinks that, among all Muslim countries, only Turkey most developed and modernized its economy by shunning the orthodox Muslim thought that Sayyid Qutb and Abul Ala Mawdudi promoted.[16]

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12 *Ibid*.

13 Cited in Mustafa Akyol, "Islamocapitalism: Islam and the Free Market," *Critical Thinkers for Islamic Reform: A Collection of Articles from Contemporary Thinkers on Islam*, Brainbow Press, 2009.

14 Ali, A. Yusuf, *The Holy Qur'an: Text, Translation and Commentary*, Lahore, 1975, p.111, n.324; cited in Ahmad, Abu Umar Faruq and M. Kabir Hassan, "Riba and Islamic Banking," at *Journal of Islamic Economics, Banking and Finance*, available at http://ibtra.com/pdf/journal/v3_n1_article1.pdf.

15 Rauf, Imam Feisal Abdul, *What is Right with Islam: A New Vision for Muslims and the West*, HarperCollins Publishers, Inc., New York, 2004, pp. 3-4.

16 Akyol, Mustafa, *op. cit*.

My Own Thoughts

As outlined in my book[17], I also argue in a similar vein. Citing the Quranic verses 2:275-276, 3:130, and 2:278-280[18], I argue that the Quran's sanction of trading (and implicitly profit) and condemnation of *riba* are predicated on the notion that profiting from trade is normal and legitimate, while *riba* is exploitative. Note, however, that though the Quran has permitted trading, it has not sanctioned exploitative trading, where the seller can dictate the price (seller's market), and where the buyer can dictate the price (the buyer's market). Exploitative or monopolistic trading gives rise to excessive or extortionate profit, which the Quran certainly does not approve of. Extortionate interest or usury (i.e., *riba*) is analogous to extortionate profit. Both deserve the same condemnation. If exploitation elements are stripped from both trading and usury, they should stand on the same footing. So it follows that interest, which can be conceived of as exploitation-free is not really disapproved of by the Quran.

I also make the point that while extending a loan, the lender should consider the financial situation of the borrower. The Arabian practice of *riba* is suggestive of the fact that the lenders at that time of history did not consider the plight of the borrowers. Where circumstances of a borrower warrant humanitarian consideration, the lender should consider lending at concessional rates, remitting interest altogether, or postponing the loan repayment (all of which come under the Quranic banner of *qard hasana*) or, still better, writing off the loan as an outright grant (or *sadaqa*), as the Quran likes us to do in 2:278-280. Thus the Quranic message of interest-free loans is applicable only for disadvantaged borrowers, who deserve to be treated with a humanitarian approach. This is *qard hasana* or a beautiful loan that the Quran talks about in several verses (2:245; 57:11, 18; 64:17; 5:12; 73:20). This is a loan without a return or interest to deserving people or entities on humanitarian grounds or on considerations of temporary financial difficulties. The question of interest cannot arise in such cases. The Quran even encourages the lenders to write off the original loans in cases where the borrowers are in difficulty to repay them (2:278-280).

Interest used in modern finance and banking is an altogether different thing. Here the very Quranic concern for maintaining justice *(adl)* demands that interest be used to compensate lenders and bank depositors in a just and fair way. Abolition of nominal interest on loans

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17 *Exploring Islam in a New Light: A View from the Quranic Perspective*, Brainbow Press, 2010; chapter on "Some Implications of the Quranic Message for the Economic System." Also available with some minor modification at http://www.academia.edu/2711261/Some_Implications_of_the_Quranic_Message_for_the_Economic_System.

18 These verses read as follows: "Those who devour usury cannot rise except as one who riseth whom the devil hath prostrated by touch. That is because they say: 'Trading is just like usury'; but *God hath permitted trading and forbidden usury. ... God blesseth not usury; but He causeth charitable deeds (sadaqa) to prosper*. He loveth not an ungrateful sinner." (275-276)

"O ye who believe! *Devour not usury, doubling and quadrupling*; and be careful of (your duty to) God, that ye may succeed" (3:130).

"O ye who believe! Be careful of (your duty to) God, and *give up what remaineth of usury*, if ye are (true) believers. And if ye do not, then be warned of war (against you) from God and His messenger. And if ye repent, then you have your principal. Wrong not and ye shall not be wronged. And *if the debtor is in straitened circumstances, then postpone (the debt repayment) till it is easy for him to repay. But if ye remit it by way of charity (sadaqa), that is best for you if ye only knew*." (2:278-280) extended in business transactions will rather result in inflicting injustice on the bankers and depositors who fund the banks.

I also point out that we should make a distinction between nominal and real (i.e., price-adjusted) interest, which Muslim scholars generally ignore. The same level of nominal interest leads to a lower real interest in an inflationary situation and a higher real interest in a deflationary situation. This will hurt the lender or the borrower respectively if the nominal level of interest is not adjusted for inflation or deflation. Thus money lending or borrowing almost invariably involves some interest element in real terms, even if no nominal interest is charged on the loan. In an inflationary situation, which is almost always the normal situation, zero nominal interest on deposits means negative real interest for the depositors. In the real-world situation, providing no nominal interest on bank deposits – so-called zero-interest in Islamic Banking terminology - thus makes little sense.

That brings us to the major causes that give rise to interest. As just discussed, inflation is one condition that gives rise to positive nominal interest. A second reason for interest to arise is people's time preference – valuing goods and money at the present moment more than at a future date. If, for example, a person would like to exchange $100 today for $110 a year after, his rate of time preference would be 10 percent. Interest plays an essential vital role in helping individuals allocate their income into present consumption and future consumption (i.e., saving) by bringing their time preference at the margin into equilibrium with the interest rate. The higher is individuals' time preference, the higher will be the interest rate that will be in equilibrium with their time preference, which means that the interest incentive will need to be higher for one to save for the future. Or which means the same thing, an individual will go on saving his present income up to the point at the margin, i.e., up to the last dollar of his saving, where he finds his time preference for this last dollar of saving equal to the prevailing interest rate. Because of individuals' time preference, it will be hard for a government or a business enterprise to mobilize saving and investment without providing sufficient positive interest on the lent money.[19]

A third, and perhaps the most important, reason for interest to arise is a return or profit that can be earned on capital invested in any economic activity such as trading, production, or provision of any service. A producer would like to borrow money to use in his enterprise so long as he earns a return at the margin higher than, or at least equal to, the rate of interest he pays on borrowed capital. The higher is the return on capital, the higher will have to be the interest rate to be in equilibrium with the rate of return situation.

In both cases, it can thus be seen that interest plays a vital role in allocating resources – in the second case between consumption and saving, and in the third case, between different uses of capital. In the third case, interest also plays the role of a rationing device, rationing

[19] Islamic banking institutions exploit the current situation where ordinary, unsuspecting Muslim believers have been led by the *ulama* to believe that receiving interest is unlawful (*haram*). They fail to see that any return on money lent is, technically or in economic parlance, interest in essence, even if it is called a "profit".

the uses of resources to the limit of the available resources. The scarcer the available amount of capital, the higher is the interest rate that will serve as an appropriate rationing device.[20]

In an equilibrium situation, the prevailing rate of interest is equal not only to the marginal rate of time preference, but also to the marginal rate of return on capital. That means that interest that is paid to depositors of a bank must be closely linked to, and must mirror, the actual profitability situation on the ground. Interest here is a substitute for the profit that can be actually earned with the money. So, this interest cannot be termed as exploitative, and is not disapproved of by the Quran.

The actual pace of economic growth in an economy also has an influence on the interest rate. The real (as well as nominal) interest rate rises with a higher pace of economic growth. Interest is lower in a slower-growing economy. Conversely, a low interest-rate regime needs to be applied in an economy where economic growth needs to be promoted. In recent years, the US and European economies have been maintaining low interest-rate regimes to stimulate economic recovery from a deep economic recession that took place in 2008.

The foregoing analysis amply suggests the crucial role interest plays in the modern economy. Economic policymakers use interest as an effective policy tool to ensure that an economy does not get overheated to generate undue inflation or it does not slide into a recession with deflation. Even a slight increase or decrease in the interest rate can work as a damper or stimulant to economic activity. An inflationary situation warrants the use of a higher interest rate and vice versa in a deflationary situation. Modern economic theory shows how interest plays a pivotal role in allocating productive resources in the most efficient manner. It plays an equilibrating role in bringing all economic forces to work in a systematic, symbiotic way toward an equilibrium situation where the marginal rate of return or profit on capital as well as the marginal rate of time preference is equal to the prevailing rate of interest.

Interest plays a central role in many kinds of economic decision-making. In both developed and developing economies, interest is a vital instrument used for directing appropriate monetary policy for achieving sustained economic growth with reasonable price stability. Countries' commercial and other banks adjust their interest rates on loans and deposits to the central rate that is governed by the central bank. Interest influences, among other things, money supply and demand in the economy, economic project planning, selection, and evaluation, inventory planning and management, and a myriad of other economic decisions. Interest represents the opportunity cost of capital. Unless a producer is conscious of such a cost, it is likely that he will engage in inefficient lines of production, use inefficient methods of production, and end up producing the wrong goods, which are uneconomic or unprofitable. Interest is an important tool used also for proper appraisal of public projects. Indeed the role of interest in economic decision-making of various kinds is so deeply entrenched that the efficient working of a modern economy is not conceivable without

[20] Capital can be used in alternative ways. One will invest in ways where the return on capital is the highest to the point where the return at the margin, i.e., return on the last dollar invested becomes equal to the existing interest rate. The interest rate thus plays both as a rationing device, i.e., it helps ration the uses of the capital to the amount of the existing available capital and it also allocates capital resources between different uses so that the possible maximum profit potential can be realized and possible misuses avoided.

interest. This is interest that plays a very useful and beneficial role in the economy. It is not exploitative interest or usury that the Quran prohibits.

What Makes Interest Unconscionable?

Interest is unconscionable (or becomes *riba*) (1) when the interest rate is dictated by any of the participating parties, (2) when the borrowing party is in temporary financial difficulty, or (3) where humanitarian considerations apply.

Competitive market forces determine interest used in modern finance. But if the competition is imperfect, i.e., if the suppliers of funds can unilaterally influence or dictate the interest rate that they use in their transactions (because of a monopolistic situation they enjoy), then the interest rate becomes unconscionable to the borrowers. Exceptional cases like this can happen sometimes, but eventually free market forces work to correct the situation, or the financial regulators take appropriate steps to correct the situation. A recent case in point is the LIBOR (London interbank offer rate) and similar benchmark rates, which were plagued with a scandal: some influential banks manipulated such rates. However, this scandal came to the notice of the bank regulating authorities who imposed hefty fines on the banks involved in the scandal, and the determination of these benchmark rates was restored to market forces as before. [21]

Whether any economic charge – price or interest – is unconscionable can also be judged in the light of the overriding fundamental principle enunciated in the Quran about social justice or good we need to observe. The Quran mandates that we strictly maintain justice or equity (*adl*) in all of our affairs (16:90; 4:58; etc.), including business dealings. It directs us to do business in particular to our mutual benefit (4:29). And it strongly urges us to respect the norms of social justice and compassion, wherever appropriate. It is for this reason that the Quran contrasts *riba* with *zakat* or *sadaqa*, condemning *riba* and extolling *sadaqa* (30:39). The Quranic message of interest-free loans is applicable only for disadvantaged borrowers, who deserve to be treated with a humanitarian approach. This is *qard-hasana* or a beautiful loan that the Quran talks about in several verses (2:245; 57:11, 18; 64:17; 5:12; 73:20). The Quran even encourages the lenders to postpone repayments or write off the original loans in cases where the borrowers are in difficulty to repay them (2:278-280). From this Quranic position and from Fazlur Rahman's analysis of the system of *sadaqa* as a broader co-operative welfare system, we get another insight that where a system of *sadaqa* deserves to be applied, interest has no role to play. But as long as we are unable to attain that welfare system, the abolition of interest would be suicidal for the welfare of a society and its financial system.

The Special Area of Microfinance

[21] LIBOR is determined by averaging the market-determined interest rates offered by a group of major banks for borrowing short-term loans from other banks. For example, for US dollar-denominated LIBOR, more than a dozen banks — including Citigroup, JPMorgan Chase, Bank of America, Barclays, UBS of Switzerland and others — estimate how much interest they would pay to borrow money on a short-term basis from other institutions. While the process is overseen by the British Bankers' Association, the calculations are now performed by Thomson Reuters. Essentially, LIBOR is one of the main rates used to determine the borrowing costs for trillions of dollars in loans. Interest rates on some mortgages, student loans and credit card accounts go up or down when LIBOR moves. Often the rates are adjusted annually or quarterly, rather than every day.

We need also to take into account the fact that side-by-side with the institutional credit market served by banks, an informal credit market also exists and operates worldwide. The informal microfinance credit market operates precisely because the formal banks do not serve the needs of all willing borrowers. Banks operate by lending against collateral. However, small businesses and poorer borrowers often lack such collateral, and accordingly they have little or no access to bank credit. Usually, because of the lack of collateral and risks involved, the interest rate charged on such loans is considerably higher than that charged by banks. Taking advantage of the unusual character of this informal microfinance credit market, even a reputable institution such as the Nobel prize winner Grameen Bank of Bangladesh, which lends to the destitute people, charges very high interest rates. In such a situation, it should be the duty of the government to bring such interest rates into line with the rates charged by the regular banks, and better still, to lower such interest rates by subsidizing the Grameen Bank in an interim period, and by introducing pro-active policies that allow more credit institutions of the same type to come into existence, which can provide competitive interest rates.

III. DOES ISLAMIC FINANCE GO WITHOUT INTEREST?[22]

Development and Relative Importance in Modern Finance

Modern-day Islamic finance and banking is only a recent innovation. The first Islamic bank was established in Egypt in 1962/63. Such banking took off in the 1970s, coinciding with an oil boom in many Arab countries, and made rapid inroads in other Muslim countries. It spread to other regions with sizeable Muslim populations, growing worldwide in double digits annually in the recent decade. Its increasing popularity has led some large Western banks to open Islamic windows. According to one estimate, in 2011, such institutions worldwide "included at least 435 full-fledged institutions, and 191 windows of conventional banks, operating over 48 countries."(Al-Muharrami and Hardy 2013) [23] "According to a 2012 survey by Ernst and Young, Islamic banking assets grew at an annual rate of 19 percent over the five years to end-2012 to reach US$1.55 trillion; growth is expected to remain strong."[24]

Note, however, that this impressive growth is not matched by Islamic banks' current relative weight in total credit supplied in many of these countries. In Sudan and Iran, the banking systems are wholly Islamic. In other Muslim countries, such banks operate side by side with conventional banks. Turkey and Bangladesh are important examples, where Islamic banking has only a marginal presence. Such banking is dwarfed by conventional banks even in

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[22] This section substantially draws on author's article "Everything You've Always Wanted to Know about Islamic Banking," on Aslan Media, available at at http://www.aslanmedia.com/arts-culture/mideast-culture/6098-everything-you-ve-always-wanted-to-know-about-islamic-banking.

[23] Al-Muharrami, Saeed and Daniel C. Hardy, "Co-operative and Islamic Banks: What Can They Learn from Each Other?" *IMF Working Paper*, 2013, WP/13/184, pp. 14-15. (Available at http://www.imf.org/external/pubs/ft/wp/2013/wp13184.pdf).

[24] Ernst & Young, *The World Islamic Banking Competitiveness Report*, 2012-13 (Available at http://www.mifc.com/index.php?ch=28&pg=72&ac=21&bb=uploadpdf); cited in Al-Muharrami, et.al., ibid, p 15.

countries like Malaysia, where Islamic banking is well developed.[25] In the largest Muslim country, Indonesia, even with a more rapid growth of Islamic banking than the conventional one, the Islamic banks accounted for a market share of only 4.2 percent of the total banking industry in September 2012.[26]

Main Characteristic Features and Investment Products

In an effort to make their operations compliant to the key requirement that no interest receipt or payment is involved, Islamic banks have devised their various products differently from the products used in conventional interest-bearing banks. Their financial products are required to be backed by real assets on the ground or linked to specific real activities, i.e., the provisions of goods or services, which themselves are not financial investments. They are barred from trading in financial derivatives to make a financial profit (although they can use forward contracts). In other words, Islamic banks are not permitted to operate on a predetermined rate of return basis. However, as we will soon see, the effort on the part of these banks to avoid interest has been only partially successful, but this also at a cost.

The main idea was to make these banks operate as private equity or venture capital firms, i.e., to operate on a profit and loss sharing (PLS) basis, allowing profits and risks to be fairly shared among the parties involved – the banks, the entrepreneurs, and the depositors. The products offered by these banks to implement this idea are called *mudaraba* (passive partnership) and *musharaka* (joint venture) contracting. Other major products offered fall in three major groups: markup or cost-plus *murabaha* (sales-based products), *ijara* (lease-based products), and *sukuk* (bond financing). *Murabaha* and *ijara* in turn have some sub-groups. *Murabaha* contracts include *bai al-inah* (sale and buyback), *bai salam* (deferred delivery sales), and *istisna*. *Bai salam* and *istisna* are used to fund goods that are yet to be produced or properties that are under construction.

Critical Evaluation

In actual practice, the PLS or equity financing principle is found to be the least used. Investment is concentrated in *sukuk* and sale- and lease-based products. Using data of a sample of 30 Islamic banks in nine Middle East and North African (MENA) countries for 2008, Salman Ali shows, as in the chart below, that *mudaraba* and *musharaka* (PLS) financing was significant only in Saudi Arabia. It was absent or considerably insignificant in other MENA countries – completely absent in Kuwait and Yemen and very insignificant in UAE and Jordan. *Murabaha* mode has dominated the financing pattern, ranging across countries from a maximum 90 percent to near 50 percent, followed by *ijara*. "On the average 75 percent of financing activity in the MENA region during 2008 was based on *murabahah*"(Salman Ali 2012).[27] As an IMF Working Paper reports, "According to statistics available from Bank Negara Malaysia, *musharakah* and *mudarabah* products constituted 5.2

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[25] Imam, Patrick and Kangni Kpodar, "Islamic Banking: How Has It Diffused?" I*MF Working Paper*, WP/10/195, 2010, p.8 (Available at http://www.imf.org/external/pubs/ft/wp/2010/wp10195.pdf).

[26] Ismal, Rifki, *Islamic Banking in Indonesia: New Perspectives on Monetary and Financial Issues*, John Wiley & Sons, Singapore, 2013, p. 20.

[27] Ali, Salman Syed, "Islamic Banking in the MENA Region," WP# 1433-01, Islamic Research and Training Institute, 2012, pp. 14-15, 35.

percent of Malaysian Islamic bank financing at end-2012, whereas *bai al inah*, *istisna*, and other *murabahah* products constituted 49.5 percent, and *ijarah* products constituted 25.4 percent."[28] According to a 1997 study, some 75 percent goes to markup or cost-plus (*murabaha*) lending and another about 10 percent goes to leasing (*ijara*) financing (Iqbal, 1997[29]). By using data for six Islamic banks of
Bahrain for the period 1991-2001, Abdus Samad finds that only 0.9 percent of such banks' total credit went into long-term PLS (*mudaraba* and *musharaka*) projects (Samad, 2004)[30]. That PLS financing features only marginally has been emphasized by other Muslim scholars as well.[31]

The reasons for Islamic banks' low PLS or equity financing are clear. There are inherent difficulties that banks face in engaging in equity financing. The banks lack needed expertise in project selection and evaluation and requisite business experience for equity investment. Also, business entrepreneurs are often reluctant to share all information with their bankers, in part, also because of their concern that this might make them exposed to tax authorities' watchful eyeing of their activities. That means that information that the concerned parties have about the PLS projects is asymmetrical, which necessarily makes Islamic banks more averse to financing such operations as involve risk and uncertainty than short-term trade or other businesses that assure certain returns.

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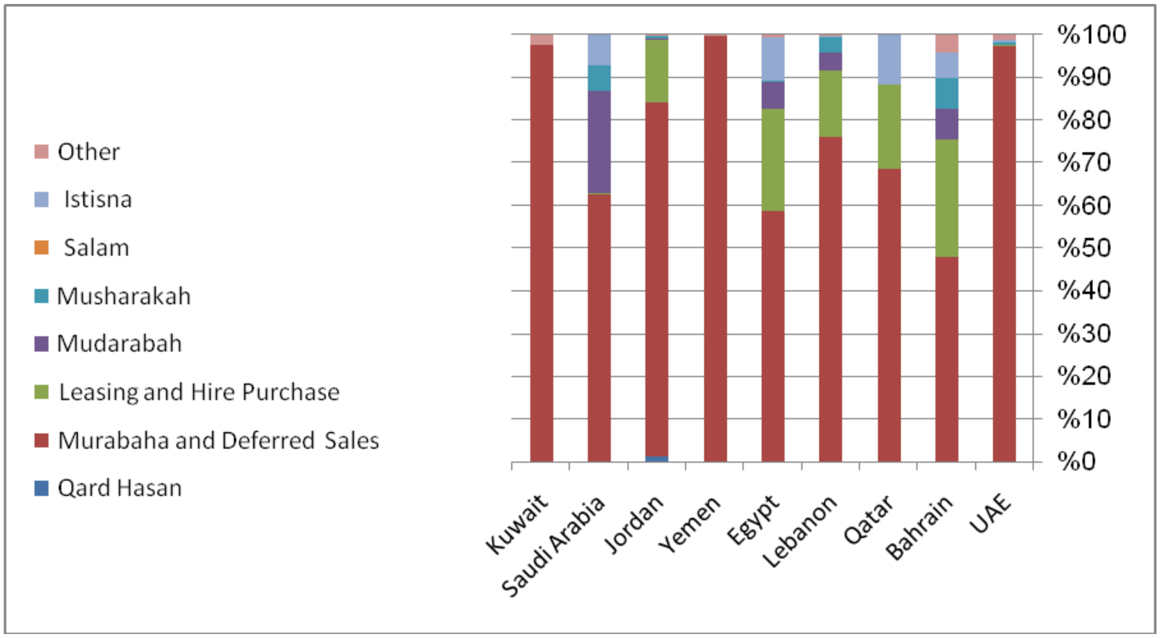
[28] Al-Muharrami and Hardy 2013, *IMF Working Paper*, *op. cit.*, p. 16.
[29] Iqbal, Zamir, "Islamic Financial Systems," *Finance and Development*, IMF, June 1997; available at *www.imf.org/external/pubs/ft/fandd/1997/06/pdf/**iqbal**.pdf.*
[30] Samad, Abdus, Performance of Interest-Free Islamic Banks vis-à-vis Interest-Based Conventional Banks of Bahrain, available at http://ideas.repec.org/a/ije/journl/v12y2004i2p.html.
[31] See, for example, Mohammad Omar Farooq, "Partnersip, Equity-financing and Islamic finance: Whither Profit-Loss-Sharing?" Associate Professor of Economics and Finance, Upper Iowa University, Draft, August 2006.

Chart: Composition of Investments of Islamic Banks Across Nine Countries, 2008



Source: Ali 2012, Figure 5.

There is another reason that explains Islamic banks' general aversion to equity investment. As Aaron Maclean writes, "Those involved in the first wave of Islamic banks realized that equity financing does not make for a stable banking sector, and, after a series of shocks and bad investments, they became very conservative. It was a race to the loopholes—a search for means of sharia compliance less risky than straight-out equity investing" (Maclean, 2007[32]).

A study done by Abdul Gafoor in 1995 sums up well the problems Islamic banks face in involving themselves in PLS contracts:

> PLS basis […] involves time-consuming complicated assessment procedures and negotiations, requiring expertise and experience. The banks do not seem to have developed the latter and they seem to be averse to the former. There are no commonly accepted criteria for project evaluation based on PLS partnerships. Each single case has to be treated separately with utmost care and each has to be assessed and negotiated on its own merits. Other obvious reasons are: a) such investments tie up capital for very long periods, unlike in conventional banking where the capital is recovered in regular installments almost right from the beginning, and the uncertainty and risk are that much higher, b) the longer the maturity of the project the longer it takes to realize the returns and the banks therefore cannot pay a return

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32 Maclean, Aaron, "Islamic Banking: Is It Really Kosher?" *The American* (The Online Magazine of the American Enterprise Institute), March/April 2007 issue, available at http://www.american.com/archive/2007/march-april-magazine-contents/islamic-banking-is-it-really-kosher.

> to their depositors as quick[ly] as the conventional banks can. Thus it is no wonder that the banks are averse to such investments.[33]

Al-Muharrami and Hardy observe:

> By sharing also upside risk with depositors, moral hazard may be reduced: bank management has less incentive than under conventional banking to make investments with relatively good chances of making very high returns and also a good chance of doing poorly. But management of an Islamic bank may have less incentive than management of a conventional bank to reduce downside risk, which too is shared with depositors. Owners and thus managers have less at stake, less "skin in the game," and may therefore make less effort to choose and monitor investments carefully.[34]

At the other extreme, small-scale enterprises find it much harder to obtain finance from Islamic banks on the PLS basis than their larger counterparts, as banks consider holding equity stakes with small enterprises extremely risky. Working capital loans, critical to many small businesses, are rare.

In *murabaha* financing, the bank is to first buy the goods from the seller and possess them for a period, thus assuming liability, as in a normal trade, and then sell them back to the buyer who wanted the goods with a profit margin on the price. However, in practice, the bank does not take possession of the goods and there is virtually no holding period involved. Thus the loan advanced by the bank is much like a normal loan of a conventional bank and the profit margin, in an annualized form, is akin to interest.

In the case of another popular instrument used, *ijara* financing, the bank collects rent with a profit on the property leased out to the buyer of, say, a vehicle or a house or some durable equipment. Let us say, the bank enters into a partnership with a person who wants to buy a house. The bank pays, say, 80 percent of the house price and the individual 20 percent. The bank rents its share of the house back to the individual until it is fully paid for, collecting rent with profit over the interregnum period. The profit collected, on an annualized basis, is little different from conventional mortgage interest. The name change does not alter the essential nature of the charge.

"Whether the product is dressed up in Arabic terminology, such as Mudarabah, or Ijarah, if it looks and feels like a mortgage, it is a mortgage and to say anything else is semantics" (Foster, 2009[35]).

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[33] Gafoor, ALM Abdul, "Islamic Banking" (Chapter 4, Section 4.3: Problems in implementing the PLS scheme of the author's book *Interest-free Commercial Banking*), 1995, Available at http://users.bart.nl/~abdul/chap4.html#4.3%20Problems%20in%20implementing%20the%20PLS%20scheme.

[34] Al-Muharrami and Hardy 2013, *IMF Working Paper*, *op. cit.*, p. 14.

[35] Foster, John (Former editor, Islamic Business & Finance magazine), "How Sharia-compliant is Islamic banking?" *BBC News*, Friday, 11 December 2009, Available at http://news.bbc.co.uk/2/hi/business/8401421.stm.

Murabaha contracts such as *bai salam* and *istisna* that involve time and credit elements on which the bank makes a profit agreeable to the bank and the buyer also involve interest in essence.

Islamic banks cannot just issue bonds (*sukuk*), a debt instrument, in return for a promise of a fixed rate of return. But they have found a way around the problem. For a bond to qualify as *shariah*-compliant, there must be an underlying asset backing it. However, the extent to which such bonds are really asset-based is a question mark. "To be Islamic in nature, the securities that look like bonds must represent fractions of an equity asset, rather than fractions of a loan" (Maclean, 2007[36]). In Iran, for example, banks use a fixed rate of return for inter-bank financial transactions and those with government departments and public enterprises with little direct relation to actual profits on the ground of borrowing entities (Gafoor, 1995, Section 4.3[37]). Also, state-owned companies and municipalities can issue *sukuk* in foreign capital markets with prior approval of Bank Markazi (Iran's central bank) and Ministry of Finance. Islamic banks are currently making roaring business in low-risk *sukuk*.

Another observer observes, "Islamic banking, in its current form, will go down in history as a mighty deceit based on an operational principle that is simply unfeasible. Islamic banks give and take interest as a matter of course, though under the guise of commissions, fees, penalties or profit shares. The holder of a "halal" credit card pays a penalty on unpaid balances; this penalty is proportionate to the size of the balance, which makes it equivalent to interest."[38]

The Turkish-American professor at Duke University Timur Kuran, who is considered a leading authority on Islamic economics, is a strong critic of Islamic finance. He "argues that Islamic finance is a faith-based fabrication that sits awkwardly in a modern business school."[39]

For the most part of their businesses, Islamic banks thus largely fail to get rid of interest. This is not a bad thing, after all. As we have seen above, Islam does not really ban interest that has come to play a very vital role in the modern economy.

Islamic banks are broadly similar to conventional co-operative banks or credit unions that are prevalent in the United States and European countries in that they both share some risk with the depositors. However, while the member-depositors of co-operative banks are also their owners, this is not the case with Islamic banks.[40]

A new 2010 IMF study finds that "Islamic banks, on average, showed stronger resilience during the global financial crisis. But the study also finds that Islamic banks faced larger

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36 Maclean, Aaron, 2007, *op. cit.*

37 Gafoor 1995, *op. cit*.

38 Barnes, William, "Islamic finance sits awkwardly in a modern business school," *Financial Times*, July 21, 2013, available at http://www.ft.com/intl/cms/s/2/ee2a2b36-9de5-11e2-9ccc-00144feabdc0.html#axzz2fGNtt2Rv.

39 Cited in William Barnes, *ibid*.

40 Al-Muharrami and Hardy 2013, *IMF Working Paper*, *op. cit.*

losses than their conventional peers when the crisis hit the real economy."[41] Also note, however, that the key trigger for the financial crisis was the housing bubble that developed in the United States due to heavy involvement in sub-prime mortgage investments by some banks, notably Lehman Brothers. Muslim countries were largely immune to this crisis as their property market has been in a sound condition. Conventional banks would have performed as well as Islamic banks in this regard, if there were sufficient financial regulation and oversight by the Central Bank.

Although Islamic banks have weathered the recent financial crisis relatively well, their overt non-embracing of the interest instrument makes them suffer from a number of serious drawbacks:

- They are deprived of a powerful tool to appraise projects on sound economic lines;
- Because they are much too risk-averse, they have ignored longer-term projects as well as small and medium sized industrial projects (SMEs) that are critical to economic development;
- These banks have difficulty also in providing working capital for existing financed projects, since it is hard to apply the principle that such capital funds cannot relate to real assets on the ground;
- They provide many of the banking services by mimicking those of conventional banks, but with the approval from one or more Muslim legal experts they hire. This practice as well as the roundabout ways they adopt to market their products lead to additional transaction costs or efficiency losses for these banks;
- Such banks also explicitly make use of conventional banks' products such as benchmark interest rates such as LIBOR (London Interbank Offer Rate) as a reference rate for the opportunity cost of finance (Curiously, contemporary Muslim jurists do not condemn such benchmark rates as unIslamic)[42];
- They also hurt depositors by making them vulnerable to risks that are usually borne by conventional banks; and
- In view of this risk-sharing feature, Islamic banks have less incentive to operate on behalf of depositors to engage in operations that can yield high returns or to reduce downside risks.

Overall, Islamic banks appear to be less efficient and growth-friendly than conventional banks. "Khalid Ikram, who headed the World Bank's operations in Egypt in the late 1990s, [and] looked into the performance of Faisal Islamic Bank of Egypt (FIBE) back during the early boom days, says of Islamic banking, 'it hasn't had a lot to do with development.'"[43] Rice University professor Mahmoud El-Gamal "condemns those who confer Islamic legitimacy to a trade simply on account of the transaction's formal adherence to the requirements of Islamic law without respecting the goal of promoting fair pricing, a practice

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[41] IMF *Survey Magazine, IMF Research*, "Islamic Banks: More resilient to Crisis? October 4, 2010, available at http://www.imf.org/external/pubs/ft/survey/so/2010/res100410a.htm.

[42] El-Gamal, Mahmoud A., Islamic Finance: Law, Economics and Practice, Cambridge University Press, 2006, pp. 74-75.

[43] Maclean, 2007, *op. cit*.

he calls 'shari'a arbitrage.'"[44] He further suggests that adherence to such formal requirements increases Islamic banks' transaction costs and leads to efficiency losses. He comments, "[D]espite the good intentions of its pioneers, Islamic finance has placed excessive emphasis on contract forms, thus becoming a primary target for rent-seeking legal arbitrageurs. In every aspect of finance – from personal loans to investment banking, and from market structure to corporate governance of financial institutions – Islamic finance aims to replicate in Islamic forms the substantive functions of contemporary financial instruments, markets, and institutions."[45]

IV. SOME CONCLUDING REMARKS

Interest has become an unavoidable, integral part of the modern economy. It plays a very powerful role as an economic development and monetary policy instrument and as an essential device for efficient allocation of productive resources. Islamic banks do not really avoid interest except in *mudaraba* and *musharaka* financing, but this financing mode is not much used. That is because of real problems of implementation or because a heavy reliance on such financing does not assure good returns to them. Islamic banks use a reference rate that is called a profit rate. But this is essentially interest in nature. But their overt non-embracing of interest deprives the Muslim economies of a very powerful tool that can help promote economic development, assure price stability, and strengthen banking, capital markets, and stock exchanges.

According to Maclean, the unprecedented economic boom in Europe over the last five hundred years was made possible, in part, by a codification made in the Christian tradition in the twelfth century of a distinction between usury and interest.[46] It's time Islamic tradition also embraces this distinction and Islamic banks come clean about their operations and openly embrace interest as a legitimate, integral part of their business.

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44 El-Gamal, 2006, *op. cit*., p.11. Cited in Mohammad H. Fadel, *op. cit*., p. 688.
45 El-Gamal, 2006, *op. cit*, p. xi.
46 Maclean, 2007, *op. cit*.

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