

ISLAMIC APPROACH TO BANKING: SOME
CONCEPTUAL AN OPERATIONAL

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PROF. KHURSHID AHMAD



ISLAMIC APPROACH TO BANKING: SOME CONCEPTUAL AN OPERATIONAL ASPECTS

By Prof Khurshid Ahmad*

Summary and Discussion Points

The bank is to the modern industrial capitalist society what the Church was to the Medieval Christendom - the centre of real power and influence. If any one institution can be described as the mainstay of the Western economy - it is the banking system. That is why Islam's abhorrence for interest, the institution on which Western banking system is based, cannot be treated as a peripheral matter. Islam challenges the very foundations of the capitalist banking system and Islamic resurgence would remain a distant hope and dream unless the prospects of an alternate banking system, capable of meeting the complex needs of a modern economy without compromising on any of the principles and norms of Islam, become " real and realizable.

In this paper we propose to briefly discuss the ethico-economic position of Islam vis-a-vis banking, focusing on selected conceptual and operational aspects. The paper is divided into three parts: the first part which is of an introductory nature, recapitulates those essential postulates of Islam which constitute the parameters within which any Islamic institution is to operate; the second part deals with the nature of the banking system, bringing into sharp focus the rationale for Islamic banking, highlighting some of the critical features of an Islamic banking model; and in the final section an effort is being made to identify some of the problems, pseudo as well as real, in restructuring the banking system to conform to Islamic norms and yet remain capable of meeting the needs of a developing economy operating in the context of a complex world economy. In view of the space (and time) constraint an effort is being made to offer only a summary of the argument.

Section 1; Islam and the Contemporary Situation

1. Islam is a complete way of life and provides guidance for all aspects of individual and collective life. Different parts of the Islamic code of life are inter-related and inter-dependent. They represent an integrated whole. Although there is every justification for! Introducing Islamic reforms in a gradual, phased manner, it must be realized that individual Islamic institutions, taken in isolation, cannot bring about the required results. As such while every institution deserves to be studied and examined in depth, its real operational significance can be understood, and the required results achieved, only in the context of total transformation of the individual and the society.

* Professor Dr. KHURSHID AHMAD is Chairman of the Institute of Policy Studies, Islamabad, Pakistan. A former Federal Minister for Planning & Development and Deputy Chairman, Planning Commission, Government of Pakistan, he is also the Chairman of the International Institute of Islamic Economics, Islamic University, Islamabad and the Chairman, The Islamic Foundation, Leicester, UK. He has authored or edited around 50 works on Economics, Islamic Economics and Islamic Studies.

2. The Islamic strategy for change consists of changing the man from within, that is, his faith, commitment, motivation, character and behavior, as well as changing the society and its institutions and mobilizing socio-political processes for the fulfillment of its objectives. This approach is very distinct from the approaches adopted by a number of ethico-religious orders which concentrated exclusively on motivational change to the neglect of institutional change, as also from the approach of the secular ideologies of our own times which structured their strategies on the premise that human situation can be changed by changing the environment. The uniqueness of Islam lies in adopting an integrated approach implying that while introducing Islamic institutions, we must not ignore the fact that motivational and ethico-social changes are as important as institutional and structural ones.
3. The Islamic economic system, an integral part of the Islamic way of life-al-Din-is concerned with all aspects of man's economic life, and not merely with the institutions of riba (interest) and Zakah (the poor-due). It has its own set of objectives, basic principles, institutions, a network of positive values and negative prohibitions, modes of relationships and incentive-system. All aspects of Islamic economic scheme are inter-related and can operate only as an organic whole.
4. In the Islamic economic scheme elimination of interest (riba) in all its forms occupies a cardinal position. The Quran and Sunnah prohibit interest in strongest terms. It has been described as an act of zulm (exploitation), as an abominable crime worst than Zina (adultery), as an act of war against Allah and His prophet (peace be upon him). Islam is so committed to abolish riba .that the prophet has severely admonished even those who act as scribes or witnesses to a transaction involving riba.
5. Riba includes interest and usury. There is no distinction between interest on consumption and production loans, as far as the question of riba is concerned. There was a time when Muslim apologetics tried to differentiate between interest and usury or between interest on consumption loans and commercial loans trying to limit it; either to the compounding of interest, for interest on consumption loans only. There is no justification for this differentiation in Shariah or in economies. The nature of interest and its exploitative character remain the same, whether the transaction is for consumption purposes or for production purposes. Any' fixed and pre-determined return in excess of the principal amount in a loan-transaction in money or in kind; is riba.
6. Islam builds economic: relationships in society on the basis of risk-sharing and participation. If the lender enjoys the guarantee of repayment then he has no right to have more than the principal amount; if he is prepared to share the risk of enterprise, then he is entitle to a variable return, whose exact quantum cannot be fixed in advance, but would depend upon the actual business performance. As such it must be clearly understood that in commercial loans Islam is NOT against the

principle of a return on loan-capital; is it opposed only to a fixed and pre-determined return unrelated to the risks of the business. This represents a unique approach to economy - it liberates the society from a class of people who are merely traders in loan-capital and are assured a return without sharing the fortunes of enterprise. It may be submitted that at the conceptual level Islam treats capital almost at par with entrepreneurship, both entitled to a share in the profit of the enterprise, and not as belonging to the category of the wage-labour or land, entitled to a fixed reward irrespective of the fortune of the business, as is the case in secular economics. This brings about a fundamental change in the role of capital, in business, and consequently in the very character of the economy. Islam visualizes an equity-based participatory society and not the one in which a rentier class dominates the economy and enjoys a permanent edge over others.

Section 2; Banking; Capitalist and Islamic Models

A modern bank deals in money and money-substitutes. Although it performs a number of financial services, its real function is to act as the chief financial intermediary between the public, the ultimate savers, and the final users, the consumers or investors in the economy, the individual, the firm, the corporation and the government. As such its key role lies in mobilizing the savings of the propel and canalizing them towards investment. Interest is the motive-power through which this process operates. The theory and practice of economics affirm that interest, which the banks offer to the depositors, is the chief determinant of savings in a society, the source of capital-formation on which the strength and development of the economy depends. It is further claimed that interest is also the chief allocator of resources in the economy. Banks provide the resources so mobilized for purposes of investment through the allocate mechanism of interest. As such both the key functions of banking (i) mobilization of-savings and (ii) their allocation for investment are performed through the medium of interest. The bank earns. Its profits through interest and other service charges. As banks are capable of creating credit, maintaining a certain ratio for liquidity, their power to finance business and industry increases manifold. Much of modern economic development owes itself to the institutional support it has received from the financial system.

Prompted by profit motive, modern banking' has played a decisive role in the development of the Western capitalist system and its international neo-extensions, imperialism and/colonialism. The industrial and technological revolutions of our times became possible only because of the resources generated by the financial power-houses, the banks. For the last three centuries the economic and political fate of the nations has been decided in the board rooms of the Western banks and even today their power to control and manipulate remains unsurpassed.

Prom the Islamic viewpoint, our real querrel is not so much with the functions of banking, as with the ideological and institutional setting in which these functions are performed and to the extent they influence the functions themselves. This ideological and institutional framework is characterized by the capitalistic spirit, the institution of interest, the exploitative character of the

whole process, its anti-egalitarian nature, and its destabilizing influences on the economy and society. This four-fold structure is represented by the following:

a. The capitalist spirit.

- Capital treated as a privileged factor
- Creation of credit almost unlimited power of the banking institution.
- Profit alone the decisive factor- leading to "shylockism" and exploitation.

b. Interest.

- Unjust to savers and to producers
- Creates a debt-ridden society - national and international levels.

Debt Finance - most credit-worthy factor - security and safety - not the most useful, or even the most profitable.

Adherence to the Concept of Financial Collateral leads to non-efficient allocation of resources.

Consumers facing credit problems; see David Caplovitz, Consumers in trouble, the Free Press New York, 1974. 50% of American families in severe debt problems. 25% of disposable income goes in debt payments.

- Leads to lower standard of living because of high prices.

"It is not uncommon to see a 26 year old come here already \$10,000 to \$ 12,000 in debt, with an average take home pay of \$ 1,000 per month, and owing that amount- to ten or fifteen creditors", A Los Angeles Consumers credit Counselor, Time Magazine. Feb. 18, 1980, page 46.

- Public Debt
- International Debt

c. Exploitation and Concentration of income, wealth and power.

"The basis of economic power is not expertise but ownership and control over abstract capital - that is, ultimate power resides with the bankers who are the major stockbrokers in and creditors of the modern large corporations."

(David M. Kotz, Bank Control of Large Corporation in the United States, University of California press, Berkely, 1978, page 148)

"It has also implications for the prevailing degree of effective aggregate concentration of economic and political power."

(David M. Kotz, "The Significance of Bank Control over Large Corporations", Journal of Economic Issues, Vol. Xli, No.2, June 1977, page 42)

- The resources of the millions are used to the benefit of a few thousand or even a few hundred thousand.
- Financial collateral: Only those who can get more.

d. Destabilization.

- Inflation built into the system of credit creation.
- Liberal credit during the boom, credit squeeze in recession cyclic fluctuations and their disastrous effects - both economic and social.

"It is not within their power to do away with some fluctuations, seeing that the latter originate not from the policy, but from the very nature of the modern organization of credit. As long as we use bank credit as a means for furthering economic development, we shall have to put with resulting trade cycles. They are, in a sense, the price we have to pay for a spread of development exceeding that which people voluntarily make possible through their savings and which, therefore, has to be extorted from them."

P.A. Von Hanek, Monetary Theory and Trade Cycles, London, page 189-190.

The Islamic Model

- Consumption - within means.
 - Just incomes and wages policy.
 - No extravagance and Conspicuous Consumption.
 - Consumers credit facilities.
 - a) Cooperative societies.
 - b) Baital-Mal - Zakat Fund.
 - c) Banks.
 - d) Welfare Organization.
- Production.
- Equity - participation direct and/or through banks
- Mudaraba Bank
- two-tier Mudaraba bank

- a) Mudaraba between depositor and bank
- b) Mudaraba between .bank and entrepreneur.
- Investment account + Current account
- special Mudaraba Schemes

Techniques

- 1) Mudaraba
 - 2) Shirakah
 - 3) Murabah – Bai ' Mu'ajjal
 - 4) Installment and leasing
 - 5) Auctioning
 - 6) Regular Credit-line
 - 7) Qard Hasan
- A) Islamic Banks - deal in equity and not merely in credit.
 - B) Project-oriented - not collateral-oriented.
 - C) Shared risk - greater vigilance - entrepreneurial role
 - D) Usefulness of investments
 - (i) Islamically acceptable venture
 - (ii) Emphasis on small investor
 - New Economic Structures
 - New Economic Relationships.

Section 3: Problems and Prospects

- 1) Is savings/capital accumulation possible at an optimal level without interest?
 - 2) As Banks will have to share losses with investors/borrowers and also with depositors, is it workable?
 - 3) There would be too many defaulters - easier to cheat the bank and deny the investor its share in profit.
 - 4) Islamic banks will face the problem of over-liquidity.
 - 5) What would happen to credit creation? Is it possible in Islamic banking.
 - 6) How Islamic banking can be introduced in the face of opposition from the prevailing system?
 - 7) How to deal with banks and other financial institution in the international field, which is steeped in interest
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