



Understanding and Eliminating *Riba*: Can Islamic Financial Instruments be meaningfully implemented?

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ABSTRACT

Elimination of *riba* has been one of the most important issues in Islamic banking and finance. Bank-interest is almost unanimously regarded as *riba*. However, all so-called Islamic banks and other Islamic financial institutions have largely used debt-like Islamic modes of finance to replace interest. This situation has created confusion among general Muslims, *ulema*, theorists and practitioners. This paper attempts to clarify some of the issues and asserts that only a *profit and loss sharing* Islamic banking can remove the negative effects of interest and provide the real benefits of an Islamic system. The paper then discusses the problems associated with a *profit and loss sharing banking* with special reference to the agency problem of *Mudarabah* highlighted by Bacha. Finally, some suggestions are provided for a genuine movement to establish a *profit and loss sharing* Islamic banking.

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1. INTRODUCTION

Riba has always been an important issue for Muslims of all eras. The reason for this is the severe warnings given in the *Qura'n* against its practice. There is no disagreement on the unlawfulness of any transaction that involves *riba*. However, there is some controversy and significant confusion revolving the issue of bank-interest as it has been practiced for several centuries all over the world.¹

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¹ For example, Sheikh Dr. Tantawi and Sheikh Wasil (previous and current Muftis of Egypt) claim that conventional banking interest is a share in the profits of growth inducing investment, and not the prohibited *riba*. Please see El-Gamal (2001), p 2.

The overwhelming majority of Muslim religious scholars as well as so called Islamic economists put both usury and bank-interest under the definition of *riba*, and call for establishment of a banking and financial system that avoids interest.

While it could be true that during Prophet's (PBUH) time, many victims of the practice of *riba* were poor consumers, there is a strong justification to claim that a number of them were traders who took loans for businesses. According to Al-Salus, the fact is that much of the *Riba*, which was used in pre-Islamic Arabia, was indeed for commercial and business financing.² Furthermore, in those days, a debtor could return less than the amount of loan if he decided to pay back before the stipulated time, another form of injustice. The following verse of the *Qura'n* can be referred to make this point and to show that the practice of *riba* could also be harmful to the creditors (or depositors in our time):

O ye who believe! Fear God, and give up what remains of your demand for *riba*, if you are indeed believers. If you do not, take notice of war from God and its Apostle: but if you turn back, you shall have your capital sums: deal not unjustly, and you shall not be, dealt with unjustly. If the debtor is in difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if only you knew. (2: 278-80) (Translation by Yusuf Ali; my italics).

According to Mahmoud El-Gamal, the meaning of the underlined sentence in Arabic given by Al-Tabari (who refers to Abu Jafar, Ibn Abbas and others) is more accurate which could be translated as "if you turn back, then you should collect your principal, without inflicting or receiving injustice" (meaning without increase or diminution, as both an increase or a decrease of the amount returned relative to the amount lent would be considered injustice).³

In our time, an injustice is inflicted on bank depositors when they are paid relatively small fraction of the income generated through utilizing their funds, and becomes especially unfair during an inflationary period. The prohibition of *riba* is, therefore, not only to discourage exploitation of the debtors but any form of injustice inflicted on the debtors or creditors (i.e., on user or supplier of financial resources).

Another related point that I would like to emphasize is that one of the goals of Islamic teachings in any sphere of life is to promote a desirable behaviour among all concerned parties. In case of Islamic banking the three parties are (i) depositors (ii) bank owners and their managers, and (iii) traders, producers and others who use banks' funds. As we will see later in this paper, elimination of bank-interest through application of profit and loss sharing financing would not only generate a better income distribution pattern (one of the most important goals of Islamic economics and finance⁴), but also lead to produce a more reasonable and justifiable attitude individually and among each other.

To replace the practice of interest by commercial banks, religious scholars and Muslim economists called for establishment of Islamic banking system based on profit and loss sharing modes of financing. Over the last three decades there has been a mushroom growth of Islamic banking and a remarkable increase in their deposits. However, most Islamic banks are heavily dependent on 'debt like' modes of financing for their earnings and the whole enterprise of Islamic banking seems to be mired

² Please see El-Gamal (2001), p. 2.

³ Please see El-Gamal (2001), p. 3.

markets for other factors of production i.e., labour, land and entrepreneurs. For a discussion on this issue I

⁴ Indeed this goal has to be achieved not only through financial markets but also Islamic reforms in the would like the readers to refer to my article, Siddiqui (1996).

with widespread confusion, less than convincing arguments, and further confusion! The majority of the contemporary religious scholars and Muslim economists treat extra earnings from *Bai Muajjal*⁵ (over and above the profit that could be made through cash price) permissible, and allow its unlimited use by Islamic banks. The original proponents of Islamic banking, for whom Islamic banking always meant *profit and loss sharing* banking, have gone into the background. The most prominent players in the field are the members of the *Shariah* Boards of different Islamic banks. Their main function is to give verdict on the validity of Islamic banking products that are largely based on juristic rulings of the past. They seem to be less concerned about the ultimate effect of their rulings in the contemporary Muslim economies.

The issue that we would like to address in this paper could be stated as follows: Is there a need for a *profit and loss sharing* Islamic banking alternative? If so, what are the prospects and what is the best way to have a meaningful and significant movement towards the establishment of a viable Islamic banking and financial system? We would like to answer these questions as follows: Section two briefly looks at some of the confusion and arguments generated over the current practices of Islamic banking. Section three describes the basic principles of Islamic banking and finance and summarizes possible benefits of a system that is truly based on these principles. In section four I discuss the reasons for non-utilization of the profit and loss sharing modes of financing by Islamic banks and other Islamic financial institutions. A critical review of Bacha's views on the agency problems associated with *Mudarabah* financing is also presented in this section. Finally, in section five some concluding remarks are made on the present status of Islamic banking and some suggestions are given for a road map for developing a *profit and loss sharing* Islamic banking.

2. CONFUSION OVER CURRENT PRACTICES OF ISLAMIC BANKS

2.1 Confusion among Ordinary Muslims:

Ordinary Muslims who lack in-depth knowledge of Islamic injunctions on these issues are confused. They read the verdicts of the *ulema* condemning interest based transactions but they do not find a single Muslim country that has developed a workable alternative banking and financial system. They are puzzled when they observe that the most widely used transactions by so-called Islamic banks are not very different from the practice of interest. They find it particularly confusing that, for example, an interest-based loan at 8 to 18 % is not permissible but a *Bai Muajjal* transaction involving an *effective* or *implicit* interest rate exceeding 50% is made permissible.

Similarly, a person can buy a car or a house on deferred payment basis but borrowing *money* from banks on interest for medical, educational and other important needs is Islamically unacceptable. It is also observed that cash strapped poor or small craftsmen and traders are happy to take short term loans even at a very high annual interest rate that allow them to make a reasonable livelihood. Many people are also not clear as to why interest is prohibited which apparently compensates for inflation and largely comes from the profits of the businesses through the commercial banks and other financial intermediaries.

The vast majority of Muslim population, therefore, leaves the issue of *riba* to the government and the *ulema* to work out a solution, and carry on with their day-to-day

⁵ Throughout this paper, *Bai Muajjal* is used to refer sale on credit with a price higher than the cash price.

business under the prevailing system based on interest. However, one can satisfactorily answer all these questions that has been raised times and again. The permissibility of *Bai Muajjal* is questionable as being discussed in the next section. Islamic banks should not be relying on this mode of finance. As far financing of genuine needs of consumer durables and homes is concerned, special financial institutions mainly supported by the government and non-profit organizations could do this on non-profit basis. The cost of running such institutions should be borne by the whole society through the government and NGOs.

The cash strapped people happily pay a very high rate of interest because they have no source of funding. This should not be the case in any Muslim society. Credit institutions on the pattern of Grameen and Khushali Banks should be giving interest free credits for small businesses.⁶

People save money for their future needs and those of their families and the easiest way to carry over these savings is to keep them in commercial banks. It is also natural that they would like these savings to grow. The only Islamic requirement is that banks invest these savings, together with their equity funds, to make proper investment on a profit and loss sharing basis. No one should think that this is a trivial job and could be done overnight. However, gradual movements in the right direction can achieve the target in fifteen to twenty years. For example, starting from zero, an Islamic bank can gradually increase the value of its assets based on profit and loss sharing modes of financing; say by 5% per year. In the mean time the rest of the assets could be based on interest and there is no need to call it mark-up or profit to create any hypocrisy or confusion. More on this will be discussed in the concluding section.

2.2 Unconvincing Arguments by Muslim Economists and Islamic Jurists:

The confusion is not confined to ordinary Muslims. Both Muslim economists and religious scholars have also been struggling to convincingly explain their position on issues such as time preference and time value of money.⁷ For example, their assertion that time valuation is possible only in business and trade of goods (to justify *Bai Muajjal*) but not in exchange of money values, is not so compelling. Similarly, Muslim jurists use verses from *Surah Al-Baqrah* (.....Allah has permitted trading (*bai*), and prohibited *riba*) to justify the permissibility of *Bai Muajjal*.⁸ However, if *bai* in this *ayah* included *Bai Muajjal*, its prevalence at the time of the Prophet must have been widespread. But the jurists fail to produce evidence to this effect.⁹ It appears to me that this is a case of understanding the meaning of a *Qura'nic* verse through a juristic verdict rather than validating a juristic verdict through the meaning or essence of the *Qura'nic* verses. The translation of the full verse is

⁶ Indeed Grameen and Khushali bank do not provide interest free loan but they do have a special mechanism of providing and collecting small loans. Islamic institutions would obviously avoid charging of any interest.

⁷ For a discussion on time value of money and its reference to *bai muajjal*, please see Siddiqui (2002).

⁸ Ibn-Abi-Hatim (died 327 AH: Tafseer, 1999, Vol. 2, p.545) had used this argument. Among others, Sheikh Nizam Yaqubi of Bahrain, a famous name among students and practitioners of Islamic banking, with whom I had a conversation during an Islamic banking conference held at Empire Hotel in Brunei Darussalam in January 2004, holds the same view.

⁹ Similarly, it would be difficult to prove that, at the time of the Prophet (PBUH), *bai salam* was used to exploit the farmers by paying (in advance) less than normal prices.

“Those who devour *riba* will not stand except as he stands who has been driven to madness by the touch of Satan. That is because they say- trade is only like *riba*, but God has permitted trade and forbidden *riba* ... God will deprive *riba* of all blessing. (2: 275-6)

Many Muslims of different levels of intellect have the notion that *Bai Muajjal*, in essence and in its implications, has characteristics similar to *riba* (except that there is no further payment required on non payment at the stipulated time; but on the other hand, there is no limit put on the difference between the cash and the deferred prices that could make the contract usurious). Does it imply that all those who naturally think this way are included in the addressees of this verse and driven to madness by the touch of Satan? The second sentence in the translation must be read very carefully where Allah *Subhanautaala* had chosen not to describe the difference between the two because it was so obvious. This could be only true if the *bai* means buying and selling of good and did not include *Bai Muajjal* (*Wallahu Alam*).

Muslim economists and Islamic jurists also fail to identify what distinctive benefits, if any, has been so far achieved by the current practices of so called Islamic banks in any part of the Muslim world. It appears that the business goes on as usual. The unlimited use of *Bai Muajjal* has generated a level of consumerism and indebtedness that prompted even a rich country like Brunei Darussalam to impose an official limit on the amount people can borrow from banks including the Islamic banks.

I agree that the acceptability of *Bai Muajjal* is widespread and deep. Strategically, it would be better to compare the outcome of the present practices of Islamic banking to one which results from a *profit and loss sharing* Islamic banking, and suggest a restrictive role of debt like financing for Islamic banks.

2.3 Current Situation in Pakistan:

In Pakistan too where technically all banks were supposed to switch to Islamic banking, the only change that happened was in name, not in substance --- interest was given the name of mark up and everything remained the same. At present, with the exception of Meezan bank in the private sector, no other bank even claims to be working on the Islamic principles. The State Bank of Pakistan (central bank of the country) has a department that is responsible for the gradual implementation of Islamic banking system. However, it appears that there is no will and desire on part of the key relevant members of the government to make any serious effort. They are either not convinced that a workable Islamic alternative is available for implementation or they find the prevailing economic and financial environment of Pakistan still too fragile for such experimentation. The same was true for all previous governments.

Recently, a number of conventional banks in Pakistan, most notably among them Standard Chartered Bank, have opened up Islamic banking windows / branches on sizable scale. However, their main emphasis is expected to remain consumer financing through *Bai Muajjal*, and as I discuss later in this paper, the benefit that may occur through a *profit and loss sharing* Islamic banking would remain elusive.

3. THE BASIC PRINCIPLES OF ISLAMIC BANKING AND FINANCE

Like other areas of social life, Islamic teachings require that transactions in trade, commerce and production of goods and services should follow some basic principles. Some of these requirements are clearly understood and largely adhered by the faithful. For example, trade or financial dealings of forbidden goods and services (such as pork,

pornography, gambling) is clearly prohibited and there is hardly any controversy about it. A clear understanding of some other requirements and their implementation is, however, far from settled. The most important of them that is relevant for banking and finance is to refrain from *riba*, *gharar* and *mysir*.

3.1 Avoidance of *Riba*, *Gharar* and *Mysir*:

Islamic scholars emphasize that *riba* (usury and/or interest), *gharar* (uncertain or unclear elements in business contracts) and *mysir* (transactions similar to gambling) should be avoided in trade and financial dealings. We have already mentioned the problem related to *riba* and will further discuss it in the next sub section. The issue of *gharar* in our time has been most frequently mentioned in the context of insurance. Many religious scholars (due to some misunderstanding) had initially claimed that dealings in conventional insurance involve *gharar*. They argued that it was not known in advance who would benefit from insurance claims in a particular period and what amount would be eventually paid in claim settlements. Furthermore, it was also contended that insurance seemed to have an element of *mysir* as it was possible for someone to claim a huge amount for which only a small premium was paid. A number of Muslim economists convincingly refuted both these claims.¹⁰ However, one of the objections that has remained valid to this date with respect to conventional insurance is that most of the proceedings of insurance premiums are kept in interest bearing instruments.¹¹ The establishment of Islamic insurance companies commonly known as *Takaful*, is to make them conforming to the teachings of Islam.

The issue of *mysir* has been often referred in the context of the working of modern day stock markets. It is claimed that stock markets are mired with excessive speculations and most people trade in stocks for making quick capital gains rather than focusing on dividends.¹² Apart from the issue of *mysir*, it could also be argued that the basic goal of a stock market is efficient financial intermediation, which can be better realized if dividend payments are directly made the focal point of the market. The same may apply to forward and future markets for commodities where the primary rationale for their establishment was stabilization of prices for both consumers and producers. It is questionable if these markets generally achieve this ultimate goal. Apparently they have become places for excessive speculation or *mysir* and need careful evaluation by Muslim economists and financial experts for their acceptability, or to come up with possible reforms to make them conform to Islamic teachings. Even if these markets do provide some useful services, their acceptance, in my opinion, should be linked with the acceptance of the general behaviour it creates among the participants.

The primary reason for establishing Islamic banking is to avoid interest, the main apparatus of conventional commercial banking. Interest being the focus of this paper, we now turn to have a deeper look into the issues related to Islamic banking and its *modus operandi* to avoid interest.

¹⁰ For an excellent discussion on this issue please see Siddiqi, M.N. (1985)

¹¹ It is also being argued that, instead of allowing some individuals or group to insure others, people facing similar calamities in future should somehow get together, form their own insurance companies and share the cost and benefits collectively. Please see Kahf (1994). Alternatively, an individual or group could offer to establish and run such companies / organizations on behalf of the subscribers who would be the actual owners of such companies.

¹² For a good discussion on this issue please see Tag-eldin (1998), Ackacem (1999) and Kia (2001).

3.2 A Further Look at the Rationale for Prohibition of Interest:

We start this sub section by again asking a fundamental question about consumption and production loan. Does Islam prohibits any payment on all types of consumption and production loans? And if so, what could be the underlying rationale for such prohibition? It is reasonable and important to admit the fact that whenever a person gives any type of loan (*not charity*) to any one, it does have an element of sacrifice in the following three senses: (i) there is anxiety whether the loan would be paid back or not (ii) a possibility of missing a profitable opportunity during the loan period and (iii) the loaned amount may be needed for important and urgent personal consumption.¹³ However, in order to promote brotherhood and fraternity among human beings, Islam prohibits charging of any interest on consumption loan. But to deny the reality that, in general, there is some sacrifice made by the lender would be wrong. Muslims are asked to make that sacrifice. Although there could be many cases in which people do feel good after giving loans to friends and relatives or to fellow human beings in distress even when they understand that there is a possibility of default. Islam *encourages* giving *Qarde Hasanah*. It also asks Muslims to give more time to the borrowers in case he/she is having problem in paying back --- all to promote humanity and a reward in the here after. The least desirable thing for a Muslim, who has been approached by a fellow human being for consumption loan, is to make an excuse gently and politely. But to give consumption loan and then ask for an increment over the original is unquestionably prohibited.

A possible objection to this assertion could be the existence of inflation in a modern monetized economy. This raises several issues: Can there be inflation (sustained increase in general price level) without increasing the supply of money beyond certain limit? If no, should an Islamic economic system then permit occurrence of inflation through its monetary policy (changes in stock of money)? If yes, then under what circumstances? Shamim Siddiqui (1994) addresses these issues and concludes that it is possible to avoid the occurrence of inflation under an Islamic economic system. However, even if we admit, for the sake of argument, that inflation is a permanent feature of any modern economic system (Islamic or otherwise) and that it is not purely a monetary phenomenon, it only allows a case for indexing consumption loans to make adjustment for inflation. The main problem with indexing even consumption loans is that it makes inflation acceptable and gives a freer hand to the government to create money. It encourages her to become prodigal and avoid taking politically harder decisions to generate financial resources (generally through taxes).

In case of production loan, the lender is allowed to accept a fraction of the profit if he also agrees to share the losses. The rationale is again based on the human fraternity and brotherhood. In Islamic system of humane relationship and social justice, it is unethical on part of some of the providers of the business funds to ask for fixed return irrespective of the outcome of the business. On the other hand, it would be unjust on part of the borrower to pay only a predetermined (small) rate of interest even if he is able to make a big fortune out of the business. Similarly, it is unjust to pay the lender a nominal rate of fixed interest when the rate of inflation is higher than this rate and the borrower is able to make a substantial profit. This is the case in Pakistan and many other developing countries where borrowing from commercial banks has become a cruel source of exploitation of bank depositors.¹⁴

¹³ This proposition is valid irrespective of whether people have a positive, zero or negative time preference.

¹⁴ The above cannot, however, be an analogy for disapproving fixed payment to labor. It is not too difficult to see through the difference. Labor is generally paid wage as current income for current

It could be admitted that some individuals in the society may not have any other resources to earn a living (an old or disabled person) but a small amount of savings which they would not want to put to risk. Some special arrangement could be made for those individuals such as creation of a welfare fund by each business using their savings in the production process, which can dispense necessary relief to them in case of a business loss. Alternatively, their savings could be put under some government department or prudent private agencies, indirectly controlled by the government, who can efficiently manage diversified portfolio even if that leads to a relatively low level of returns. But on the pretext of presence of such individuals (e.g., old or disabled persons), a general permissibility of institution of business interest goes against the Islamic sense of social justice.

Similarly, the need of financing for consumer durables and housing, and small loans for businesses are very important. However, the best way to tackle these financing in an Islamic society is to establish specialized financial institutions that give loans for genuine needs without interest. The cost of running such institutions should be borne by the government. This will restrict the expansion of consumerism and compel the banks to directly involve in productive activities rather than chasing and persuading consumers to give them loans.

3.3 Conventional and Islamic Banking:

The main difference between the two banking systems is that Islamic banks are supposed to work without charging and giving interest. Rather than charging a predetermined fixed rate of interest to those who want to use banks' funds for trade, commerce and production, Islamic banks are ideally required to have a profit and loss sharing arrangement with them. On the other side, the depositors have two choices. First, they can keep all or part of their money in an Islamic bank in a no-risk account. The bank will keep this money as safe deposit and guarantee the principal amount (it could be suggested that Islamic banks should not use these deposits for investment i.e., a 100% reserve requirement for such accounts). Alternatively, depositors can choose to put all or part of their money in investment accounts. Islamic banks will use the proceedings of these accounts to make investments in trade and production. The profits made by Islamic banks are then shared with depositors. To avoid *gharar*, the details of profit and loss sharing arrangements are *completely* and *clearly* known to all parties in advance.

The Islamic sense of social justice requires that all parties directly or indirectly financing in a business should share the risk of the business. The banks should combine shareholders' equity funds with those of their depositors and provide these funds to the ultimate users: traders and producers. All parties of this business arrangement should share the benefits as well as the risks of these investments.

Conventional banks have to guarantee the principal and accrued interest by law, whereas Islamic banks will violate their very basic principles if they give such guarantee (to the investment-deposit holders). In principle, Islamic banks are not supposed to ask for collateral. In order to avoid risk, the integrity, capability/competence of the potential user of banks' funds (or the entrepreneurs) and the viability of the trade or business proposal are given much more importance in comparison to conventional banks.

consumption for living. There is nothing wrong if a well to do labor risks all his labor for a share in profit, or some workers agree to link part of their income to uncertain performance of the business entity. But to expect that workers in general should agree to exchange their labor totally for an uncertain income will be unjust.

Banks being equity provider of a business would be given the right to inspect all financial accounts of the business. This is normally not the case when conventional banks provide loans on interest.

A number of conventional commercial banks all over the world go bankrupt every year due to bad loans or bad economic condition or both. To be competitive, Islamic banks have to be prudent and efficient. However, even when banks are working prudently, they could still face insolvency due to an overall downturn in the economy. The sharing principles of Islamic banking would channel negative consequences of a genuine downturn to all parties involved: depositors, banks and traders/producers. The depositors may get a lower than normal return in some years. In extreme cases, a negative return is also a possibility. However, one should also keep in mind that when most businesses would realize better returns, both shareholders of Islamic banks and their depositors should also receive higher than normal returns.

3.4 Islamic Banking in Theory: Some Suggested Advantages

A number of theoretical works examined the implications of preferred Islamic modes of finance in the contemporary world. In their theoretical work, Siddiqui and Zaman (1989a & 1989b) have shown how the application of *Mudarabah* and *Musharakah* techniques of finance has the potential to enhance investment and could also generate a more equitable desirable income distribution pattern.¹⁵ Their models confirm the intuitive point that compared to a debt arrangement, both under deterministic and probabilistic framework, *Mudarabah* and *Musharakah* finance could lead to higher level of investment as new (marginal) projects would be under taken as long as they are expected to give a positive rate of return, however small those rates might be.¹⁶ It also shows that under these Islamic techniques of finance, compared to a debt system, a greater portion of profits is allocated to the providers of funds if the economy is doing well. On the other hand, in bad conditions, the providers of fund receive a lower return and in extreme cases they may get a negative return. This has a stabilizing effect on the economy.

Siddiqui (1994) further discuss how an economy based on the institution of interest is inherently unstable (a proposition so elegantly presented and championed by prominent Post Keynesian economist, Hyman Minsky) and how the Islamic techniques of finance based on profit and loss sharing have the potential to provide financial stability. It emphasizes the point that *Mudarabah* finance is particularly capable of attracting those potential capable entrepreneurs who are unable to provide any collateral. This possible increase in the supply of entrepreneurs would decrease the power of existing entrepreneurs and can lead to a desirable distribution of income by discouraging concentration of wealth in fewer hands. Siddiqui (1994) also addresses the problems one would face under Islamic techniques of finance and argues that those problems are not insurmountable. He points out that any serious attempt to implement profit sharing financing would require, at the initial stages, commitment and often supervision and intervention by the government.

¹⁵ Siddiqui (1989a, 1989b).

¹⁶ Under a debt arrangement projects are not under taken if the rate of return is less than $1 +$ the rate of interest.

4. INSIGNIFICANT USE OF PREFERRED ISLAMIC MODES OF FINANCE

The insignificant use of preferred modes of Islamic finance such as *Mudarabah* and *Musharakah* has become a dilemma for Islamic banks throughout the Muslim world. While Islamic banks have grown in number and have shown spectacular success in deposit expansion, their credibility in using the available funds through preferred modes of Islamic finance that could bring in some of the benefits we have just discussed is yet to be established. We now turn to contemplate on the reasons for the lack of progress on this front.

M. N. Siddiqi traces the practice of *Mudarabah* finance through several centuries of Islamic history.¹⁷ He points out that although this mode of finance was mostly used in trade, it was also applied in other activities. He asserts that its application to agriculture, manufacturing, services and financial sectors in the contemporary world should not pose any serious problem. He further claims that application of this mode is particularly suitable for the financial sector where suppliers of capital and entrepreneurs interact. An important conclusion of this article is that application of *Mudarabah* finance in the non-trading sectors of the present time does not violate any of the basic principles of *Mudarabah* finance evolved in the past. For example, the fact that most industrial projects involve longer time than the trading activities should not create an insolvable problem. He admits the fact that finance provided to existing industrial units on profit sharing would certainly create a problem of assessment of the contribution made by such finance. However, he claims that the problem of calculation could be rather complicated than insurmountable.¹⁸

Deviating from the traditional view, M.N. Siddiqi also suggests that in the *Mudarabah* mode of finance, *Rab-ul-Mal* can also choose to participate in the management of a profit sharing scheme. Finally, he applauds the *entrepreneurial* role of Islamic banks and their ability to efficiently allocate financial resources of their depositors. To give proper incentive, he advocates that Islamic banks should be allowed to take a share of the profits. A predetermined fee for the banks for their intermediary function, in his opinion, would give them less incentive to maximize profits for their clients.

M.N. Siddiqi, however, admits that Islamic banks have generally resorted to *Murabaha* financing.¹⁹ The low levels of honesty and trustworthiness in the market, the poor system of audit and accounts, lack of means for monitoring a business and failure of the judiciary in helping the financing agencies in case of default by fund users, are some of the reasons given by him for the trivial use of *Mudarabah* finance by financial intermediaries.

4.1 Bacha on *Mudarabah* and *Mudaribs*

Bacha has attempted to explain why the share of *Mudarabah* financing has been negligible in overall financing of Bank Islam Malaysia.²⁰ As Bacha's models are the most sophisticated attempt to highlight the inherent problems of *Mudarabah* finance, I

¹⁷ M. N. Siddiqi (1991), pp. 21-31.

¹⁸ Siddiqi (1991), pp. 26-27.

¹⁹ Siddiqi (1996), p. 1.

²⁰ Bacha (1995), pp.40-43 & (1997), pp.58-62. Bank Islam Malaysia is not the only Islamic bank which has been unable to use *Mudarabah* and *Musharakah* finance at a large scale. We have mentioned above M.N. Siddiqi's recent observation that most Islamic banks have similar records.

would like to deal with it at length. He uses a series of theoretical models and several concepts widely used in mainstream literature on finance. He stresses that *Mudarabah* financing is susceptible to acute *agency* problem. He claims that when compared to western techniques of finance, *Mudarabah* contains certain features of both debt and equity finance. To a *Mudarib* (or entrepreneur), the *Mudarabah* financing that he gets from an Islamic bank is like conventional equity for the following reasons: (i) there are no fixed annual payments that are due (ii) payments made to Islamic banks come from profits much like dividend (iii) Islamic banks cannot foreclose or take legal action if there are no profits and therefore nothing to be shared and (iv) like equity, using *Mudarabah* financing does not increase a firm's risk as debt financing does through increased financial leverage. On the other hand, according to Bacha, *Mudarabah* financing has following characteristics that make it closer to debt financing: (i) it represents a fixed claim by Islamic bank on *Mudarib's* company (ii) like debt, *Mudarabah* financing is terminal, and that is, the arrangement can be ended by mutual agreement or by one party. The *Mudarib* can end the relationship by repaying the principal and accrued profits to the Islamic bank.²¹

According to Bacha, as *Mudarabah* financing has the features both of debt and equity financing, agency problems associated with both debt and equity finance are thus present in *Mudarabah* financing. Moreover, as *Shariah* prohibits the *Rab-ul-Mal* from interfering in the business and at the same time makes him liable for all the losses, agency problems of *Mudarabah* financing are more severe than debt or equity.²²

Like equity finance, in *Mudarabah* financing, a *Mudarib* has every incentive to increase those costs which accrue to him as benefits. Similarly, in case of financing a new project or to establish a new subsidiary, a *Mudarib* will have all the incentives to allocate as much overhead and other costs of his original (or parent) company, to the *Mudarabah* financed project or subsidiary. The shuffling of profits from one unit to another does not happen in conventional equity financing since equity has an unlimited and perpetual claim on all of the company's assets.²³

Bacha further claims that, compared to equity finance, *Mudarabah* financing constitutes a fixed and terminal claim as does debt. The agency problem of debt finance i.e., *levered equity as call option on the firm*,²⁴ remains in *Mudarabah* finance though in a slightly altered form.²⁵ Furthermore, the incentive to take on risky projects would be even greater in *Mudarabah* as *Rab-ul-Mal* takes all the losses.

With the help of his model and working with some hypothetical data, Bacha shows how *Mudarabah* financing in its traditional form cannot be attractive to any Islamic bank in the contemporary world. Compared to debt, *Mudarabah* financing generally gives lower return to the financier with higher variance. Using equity, the financier can get much higher return with almost same variance as *Mudarabah*.

²¹ Bacha 1997, p.59.

²² Bacha, 1997, p. 61.

²³ Bacha, 1997, pp. 61-62.

²⁴ Levered equity as a call option on the firm refers to the resulting payoff to an equity holder when he combines his equity with debt financing. Since equity represents a residual claim whereas debt a fixed claim on firm's assets, an equity holder who uses large amounts of debt to finance a project tries to keep all accumulated value beyond the fixed claim of the debt holder. Should the project be successful, this residual value that accrues to equity holder could be really large. On the other hand, if the project fails, equity holder's loss is limited to his equity. The payoff to such a situation resembles the payoff to a call option (Bacha, 1997, p. 60).

²⁵ The share of a *Mudarib* in a *Mudarabah* is less than one. However, his liability is also much limited in case of a *Mudarabah*.

In order to resolve agency problems of *Mudarabah* financing, Bacha suggests *equity kicker* solution derived from conventional finance. He proposes that in case there is a loss in a project funded through *Mudarabah* finance, the financier may accept the loss. The *Mudarib*, however, should reimburse the loss through issuance of new equity to the *Rab-UI-Mal*. In case of a project financing or financing a subsidiary, the reimbursement should be capped at a percentage equal to the proportion of *Mudarabah* financing to total firm value at the time of initial financing.²⁶ It may appear that the financier is guaranteed against losses. However, Bacha claims that the same is not true, as *Rab-UI-Mal* would still suffer losses if *Mudarabah* financed project turns out to be bad. Bacha asserts that the main problem with *Mudarabah* financing is that the *Mudarib* does not share any loss. Once that provision is revised and the *Mudarib* is forced to take on some of the “brunt”, the agency problem of the *Mudarabah* finance would be minimized. He points out that in today’s world especially in the corporate sector, it is hardly desirable that the *Mudarib* be exempted from sharing any loss.²⁷

4.2 An Evaluation of Bacha’s Arguments: Can Equity Kicker Mould Entrepreneur’s Behaviour?

A detail critical examination of Bacha’s model and the results of his specific numerical example, are given in Siddiqui (1998). Here I would like to address Bacha’s valid assertion that *Mudarabah* contract involves relatively greater problem of moral hazard. In the interest system, the borrower not only commits to pay back the principal amount and the interest but also provides collateral to a financial intermediary. He thus has relatively less incentive to misappropriate the borrowed funds. This arrangement is necessary if the providers of the funds have to be assured of their principals plus interest. This is well known fact. However, the interest system has its own disadvantages that I have already mentioned above. The main problem with that system is that funds are provided to those who could provide collateral, making rich richer. The integrity and honesty of the borrower is given *relatively* less importance compared to his ability to provide collateral. On the other hand in case of a loss, all the loss is borne by the borrower. An economic slow down can thus create wide spread bankruptcies and linger the recession whereas in a booming economy most of the (abnormally high) profits goes to the borrowers of the funds. Depositors generally fail to get a better or fair share of these abnormal profits, as rates of interest paid to them are slow to adjust and generally have narrow limits.²⁸

The problem becomes more difficult if we have a two tier *Mudarabah* such as the situation faced by the Islamic banks. They have a pool of depositors whom they have persuaded that Islamic banking is better than other commercial banks and would bring in better rates of return although in theory the returns are uncertain. However, the banks are convinced that their depositors would go away if they do not give them a rate of return commensurate with the commercial banks working under the interest system. Now if their main assets are based on *Mudarabah*, *Musharakah* and leasing, there are chances of default (or they may invest in long term projects). As Islamic banks are unsure about the probability of such situation and how to handle the problem

²⁶ Bacha, 1997, pp. 73-74.

²⁷ His argument being that in the old days it might have been justified. He does not give any reason but perhaps he is assuming that, for some reason *Mudarib*’s were generally people with no financial resources.

²⁸ Siddiqui (1998), p. 17.

if it does become a reality, they have chosen to completely avoid such a scenario. This is why most Islamic banks have used *bai muajjalas* their main financial vehicle to assure a reasonable rate of return to their depositors. However, as mentioned earlier, by doing so many people see them as a continuation of the traditional commercial banking. Furthermore, they have also failed to observe the benefits of Islamic banking as claimed by Islamic banking theorists.

Mudarabah finance is appropriate for two persons (or two groups of people), one of which has the financial capital but does not have time or skill or temperament to be involved in a business. The other has willingness, time and skill but lacks required capital to launch a particular business. In a *Mudarabah* finance, a fundamental principle is that *Rab-UI-Mal* knows that the *Mudarib* lacks financial resources. However, he would put the financial resources under *Mudarib's* disposal if he has confidence in the competence, honesty and integrity of the *Mudarib*. The *Mudarib* may be able and hence could be asked to provide a small fraction of the required finance. However, *Rab-UI-Mal* must agree to give *Mudarib* a portion of the total profit which is higher than his share of contribution to the business.²⁹ This is in return to *Mudarib's* efforts in visualizing, initiating and successfully executing a project. Furthermore, *Mudarabah* contract may contain a clause that could allow the *Rab-UI-Mal* or his nominee to inspect or audit financial accounts for the project without interfering or challenging *Mudarib's* day to day business decisions. Similarly, with mutual agreement, the *Mudarabah* contract may also allow the *Rab-UI-Mal* to take part in the management of the business. A well functioning legal framework with provision of appropriate penalty for the party that breaches the contract or misappropriates the funds would further reduce the moral hazard problem. However, in case of a loss, without any evidence of misappropriation on part of the *Mudarib*, penalizing him through equity kicker seems to go against the principle of Islamic social justice. Moreover, there is no reason to believe that an equity kicker would reduce the moral hazard problem. Once the integrity of a *Mudarib* becomes questionable, the *Mudarabah* arrangement cannot continue smoothly. If the *Rab-UI-Mal* thinks that the *Mudarib* has misused his *Ras-UI-Mal* but is unable to produce any evidence, the *Mudarabah* contract may have a clause to allow him to get his investment out of the business.³⁰

The possibility of moral hazard cannot be removed from a *Mudarabah* contract to that extent which is possible in interest-based finance. It would be, therefore, necessary to have a thorough investigation about the competence and integrity of the potential *Mudarib*. If, in a society *Rab-UI-Mals* cannot find *Mudaribs* with such qualities, and an appropriate legal and judicial framework under which the contract is made and controversies are resolved between *Rab-UI-Mals* and *Mudaribs*, the institution of *Mudarabah* cannot work adequately. If it is argued that the above mentioned qualities are difficult to find among the contemporary Muslim societies, then *Mudarabah* finance may not become a major vehicle of Islamic financial system and one has to rely on other Islamically permissible techniques of finance such as *Musharakah* or equity finance and leasing. *Mudarabah* finance cannot become attractive *only* on the strength of an elaborate and up to date legal framework. The existence of honest and competent *Mudaribs* is the other wheel of the vehicle without which the system will remain, by and large, non-operative. However, as no significant study is available to prove the non-

²⁹ A similar arrangement is present in *Modaraba* regulations in Pakistan where the sponsor or managers of a *Modaraba* receive, apart from the return to their own capital, 10% of the profit of the *Modaraba*.

³⁰ Siddiqui (1998), p. 18.

availability of potential *Mudaribs* with the desirable qualities, it remains to be seen whether *Mudarabah* would become an important mode of finance in future.³¹

One can also argue that the situation may not be that dismal. No body can deny the existence of dishonest businessmen who would not leave any opportunity to cheat. But there are many who would not. More important, there are many potential businessmen among existing Muslim societies, Muslims and Non Muslims, who are honest and skillful but lack financial capital. This is not to say that all current entrepreneurs are crooks and cheaters. The interest system gives *relatively* more weight to the ability of an entrepreneur to provide collateral than to his honesty and integrity. Honesty and competence, though important, do not get appropriate weights in qualifying for a loan. They are, therefore, not used on same scale by potential borrowers for *signaling* purpose. The behavior of economic agents is, to at least some extent, dependent on the system they are working in.³²

Every proposal to make *Mudarabah* finance more attractive for *Rab-Ul-Mal* (which could also be made acceptable to *Mudarib*), should be given serious consideration. This include allowing the banks to look into the accounts of the *Mudaribs*, some room for being involved in business decision making, and establishment of speedy banking tribunals to settle disputes. It would neither destroy the basic character of this mode of finance nor go against the norms of Islamic social justice.

5. WHERE DO WE STAND TODAY AND WHERE TO GO FROM HERE?

As mentioned earlier, a common observation made by general public, conventional bankers, Muslims and non Muslims is that the modes of finance currently used by Islamic banks and some other financial intermediaries such as *Modarabas* of Pakistan, are primarily not very different from those of the conventional banks. The members of the *Shariah* Boards as well as the managers of the existing Islamic banks would, however, not accept this contention.

Some Islamic bankers even claim that their techniques do not have to be very different from the conventional banks. They give the examples of *Zabiha* and *Nikah* and claim that, by giving an Islamic name and brining in a "meaningful intention" they Islamize a financial transaction even if the end result is not very different! With this claim, many Islamic bankers assert that they have already achieved the goals of Islamic banking! This is very true for Malaysia that is seen by many as one of the pioneers and current leaders in Islamic banking. The Islamic scholars of this country who sit on the *Sharia'h* boards of the central bank and other Islamic financial institutions have even allowed a mechanism or process of documentation, which effectively allows granting simple cash loans with a mark up. The transaction does not involve any real sale or purchase of any commodity or service. Indeed this practice is questioned by almost everyone outside Malaysia (and Brunei which exactly follows Malaysian model for its own Islamic banks and other Islamic financial institutions).

On the other hand many Islamic economists and theorists are dissatisfied with the prevailing situation in Islamic banks. Many of them now believe that the whole project of Islamization of the banking sector has been put on to the wrong direction. The prime reason for this state of affairs is the unlimited and unquestionable use of debt like techniques of financing. They point out that elimination of interest requires

³¹ Ibid, p. 19.

³² Ibid.

establishment of an alternative financial system that is compatible with an overall economic system which assigns social justice as one of its key goals. They emphasize that a truly Islamic banking and financial system would be based on an optimal sharing of *risk* and *returns* of the businesses by all parties concerned i.e., depositors, bank owners, ultimate users of funds. This would naturally lead to (i) a better income distribution pattern (ii) increased financial stability, and (iii) a more humane attitude among all parties concerned.

The permissibility of *Bai Muajjal* is now widely endorsed by religious scholars of different school of thoughts as well as many Islamic economists. Although, I am personally not convinced, I think the best way to proceed is to let them accept that even if *Shariah* approves this debt like financing, its unlimited use by Islamic banks is less desirable and more emphasis should be given to establish a *profit and loss sharing* Islamic banking.

One can understand that existing Islamic Banks are concerned about the attitude of their depositors who would generally like to get a rate of return not less than what is given by the conventional banks. They may fear that a sizable number of the depositors would take away their deposits if Islamic banks give lower returns. This fear, combined with their perception that growth of deposits is the key measure for success of a bank, has tempted them to go for *sure* returns through transaction based on deferred payment and mark up.

5.1 How to Move Forward?

Any new system competing against a well-established structure that has prevailed for centuries will naturally require strong efforts in the beginning. Many religious scholars who consider bank-interest under the definition of *riba* call for an immediate abandonment of the institution of interest. They claim that once you stop business dealings involving interest, things may be disturbed for a while but eventually it would stabilize for the better. They also emphasize that obeying the command of Allah *Subhanautaala* will certainly bring in his blessings in ways that we fail to imagine beforehand.

Other scholars and most Islamic economists who share the view that *riba* includes bank-interest do not see the need for a complete and abrupt discontinuation of this institution and suggest a gradual move towards a system that would eventually avoid interest. I agree with this suggestion and propose a two-way strategy. First, the government may ask all the banks to increase their profit and loss sharing assets by a small percentage every year. This percentage could be as little as 3 to 5 %, and allow the banks to excel in such financing. Second, the government can encourage establishment of model *profit and loss sharing* Islamic banks in the private sector and provide necessary help. These model banks may have an accelerated target for excelling in profit and loss sharing banking.

The model Islamic banks should be run by professionals who firmly believe in the *need* and *practicality* of *profit and loss sharing* Islamic banking. The initial deposits in these model banks should come from the government and / or committed Muslim individuals. At the initial stages, the bank should caution or even discourage common depositors by refusing to promise or guarantee *good* returns on their deposits. Only after excelling in techniques of profit sharing financing, they should encourage deposits from common people and gradually minimize the role of government funds.³³

³³ Siddiqui (1998), p. 20.

Theoretically, Islamic banks could also be allowed to invest in stock markets. As the basis of stock market investment is profit and loss sharing mechanism, it seems to be obvious. The problem, however, is that dealings in stock markets are mired with excessive speculation or *mysir*. To safeguard the interest of the depositors, even the developed countries put restrictions on their commercial banks to invest in stocks. Islamic economists have given several suggestions to reform the existing stock market regulations to make it compatible with Islamic teachings.³⁴ This is a new research programme and there is need to do more investigation in this area. One thing that seems to be clear is that, good corporate governance and the importance of dividend payments over quick capital gains would be the central theme of any Islamic reform agenda for dealings in stocks. It is interesting to note that again the role of entrepreneurs / *Mudaribs* would be crucial for the success of such reforms.

In the mean time, the government must also provide a conducive environment by establishing speedy banking tribunals and making necessary changes in laws that protects the genuine interests of all parties concerned.

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³⁴ For example see Taj-El Din (1998), Akacem (1999) and Kia (2001)

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