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Towards Interest-Free Banking

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This book is of uneven merit. It contains a fairly good account of the attitudes towards the institution of interest through the ages. It also contains a fairly elaborate critique of the various theories of interest which have sought to justify a return on capital in the form of interest. However, its exposition of interest-free banking is marred by a number of deficiencies which seriously detract from the value of the book.

The author rightly points out in the first chapter that all great religions have opposed interest. He then analyses the arguments that have been put forward from time to time in justification of interest. Special attention is given to theories which justify interest on the basis of time preference and liquidity preference. Logical contradictions in some of the theories of interest are clearly brought out, and some of the basic assumptions underlying these theories are ably criticized. There is also an interesting account of how even eminent economists confuse between the concepts of interest and profit.

There is widespread agreement among Muslim scholars that, keeping in view the injunctions of Islam, the ideal alternatives to interest in an Islamic economic system are

(*) Shaikh Mahmud Ahmad passed away on 22 May 1990 at Lahore. He was 72. Shaikh Mahmud Ahmad was among the pioneers, having published his Economics of Islam in 1947. He remained dedicated to the cause of Islam and Islamic economics till the end. May Allah grant him forgiveness and mercy and reward him for his services. (Editors)

profit/loss sharing and *qard hasan.* Almost all the theoretical contributions on the subject of interest-free banking give pride of place to *mudarabah* and *musharakah* as the two most prominent forms of profit/loss sharing arrangements on which the foundations of Islamic banking can be raised. It is recognized that while profit/loss sharing is the real alternative to interest in an Islamic economy, resort can be taken to other techniques, which are not prohibited in Islam, if the application of the system of profit/loss sharing in certain situations gives rise to special difficulties. Some of these techniques are *bai muajjal/murabaha* (usually translated as cost-plus trade financing or 'mark up' financing), *ijara* (lease or hire), *ijara wa iqtina* (hire-purchase), and *bai salam* (pre-purchase agreements). The author of this book, "however, takes a different line. He is of the view that "no significant device has been evolved by Muslims as a substitute for interest" (P 15)[*]. *Mudarabah* and *musharakah* are pre-Islamic arrangements and "both suffer from identical inapplicability on a major part of the economy" (p.15). The other techniques are regarded as "indistinguishable from interest" (p.15). A little further on, the author asserts that "the only concept available in Islamic thought which does not suffer from either a speck or a stain of interest is that of *qard hasan*" (p.16).

The author is of the view that "*Shirkah* and *Mudarabah* are excellent devices to eliminate interest in personal dealings" but "as soon as we enter the realm of institutional credit, the workability of both these concepts contracts, while problems connected with their application multiply, rendering both these concepts virtually obsolete" (p. 44). The author gives three reasons for the "obsolescence" of *mudarabah* and *musharakah.* Firstly, these techniques cannot be applied to provide resources to the government to cover their fiscal deficit. Secondly, they cannot be used in the case of consumption loans. Thirdly, "even in the case of productive loans, the number of borrowers precludes supervisory arrangements under either of these two concepts" (p.45). While summarily dismissing *mudarabah* and *musharakah* as viable substitutes for interest on such reasoning, the author takes no notice of the extensive literature on interest-free banking which contains answers to his concerns. None of the writers on interest-free banking has taken the position that all the operations of interest-free banks have to be conducted on the basis of *mudarabah* and *musharakah.* It is generally agreed that, in an interest-free economy, some resources of the banking system will be set apart for being provided on *qard hasan* basis. The rationale for the provision of some resources of the banking system to the government in the form of interest-free loans has been set forth in many writings[(1)]. The justification, briefly, is that banks will pay no return on demand deposits in an interest-free framework and should be expected to make some resources available to the government to finance socially necessary projects on interest-free basis. Moreover, unlike the position taken by the author, the possibility of using the techniques of *mudarabah* and *musharakah* in financing a part of government expenditures is not ruled out by other writers. It has rightly been pointed out by these writers that these techniques can be used to finance such public enterprises as are expected to yield a reasonable profit[(2)]. The residual requirements of the government can be met by interest-free loans from the central bank of the country.

(*) Here and elsewhere page numbers in parentheses refer to the book under review.
(1) See, for example. **M.U. Chapra,** (1985). pp. 161-l63.
(2) See, in this connection. **M.N. Siddiqi,** (1983). pp. l32-l42.

The literature on interest-free banking has also dealt with the mechanisms that can be used to meet the loan requirements for consumption purposes. It has been pointed out by many writers that ideally the provision of consumption loans to the needy should be the responsibility of the social security apparatus of the state(3). A limited amount of such loans can also be provided by commercial banks to their account holders for which a service charge an be recovered(4). Writers on interest-free banking see no difficulty in organizing a system of finance for those who wish to purchase consumer durables on installment payments basis. Interest-free banks can provide finance to firms engaged in the business of instalment sales on profit sharing basis(5).

The author regards *mudarabah* and *musharakah* as unworkable substitutes for interest in the case of productive loans because of the difficulty of making supervisory arrangements to cover a large number of borrowers. There is no denying the fact that banking on the basis of profit/loss sharing (PLS) entails greater supervision compared to intrest-based banking. However, given adequate staff and appropriate supervising techniques, there is no reason why the PLS system should not be able to deal with a large clientele. The degree of supervision needed in *mudarabah* financing is minimal because of the very nature of a *mudarabah* contract. Financing on the basis of *musharakah* also does not necessarily involve too detailed a supervision over the affairs of the users of such finance. In the case of well established firms with good business reputation, there will hardly be any need for the financing bank to set up elaborate supervisory procedures. In cases where a need exists for greater monitoring, appropriate supervisory techniques can be worked out. It is acknowledged by writers on interest-free banking that costs of monitoring would be higher in the case of PLS system compared to the interest-based system. However, they also point out that these costs are likely to be more than offset by the increased profitability of PLS system under normal circumstances.

The author regards the other financing techniques being used by Islamic banks as subterfuges, indistinguishable from interest, devised to evolve some method of rewarding capital (p.15). There is a good deal of literature now on the controversy surrounding these other financing techniques. Though very few share the view of the author that these techniques are indistinguishable from interest, most writers caution against widespread use of these techniques because they are not capable of making any significant contribution toward achievement of the objectives of the Islamic economy(6). The financing technique known as *bai al-muajjal* has aroused greatest controversy but even in this case, as the author himself acknowledges, a number of *fuqaha* (Islamic jurists) have accepted its validity (p.45).

While discussing the various financing techniques, the *fuqaha* have laid down the conditions that must be fulfilled to ensure that they conform both to the letter and spirit of Islamic teachings. A large number of Islamic banks operating in different countries have a Religious Supervisory Board so that managements of banks can have easy and

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(3) See **M.N. Siddiqi**, (1982), p. 34.
(4) See **M. Mohsin,** (1982), p. 193.
(5) See **M.U. Chapra,** (1985), pp. 130-132.
(6) See, for instance, **Abbas Mirakhor**, "Short-term Asset Concentration and Islamic Banking", in **Mohsin S**. **Khan** and **Ahhas Mirakhor**, eds. (1987).

continuous access to religious scholars for consultations in evolving the operating procedures of the banks, and the scholars in turn have full opportunity of scrutinizing their actual operating procedures. In the absence of such arrangements, there is a risk that some of the operating procedures may not conform to the Islamic norms. This is in fact what has happened in Pakistan where some of the practices adopted by banks during the course of the switch over to interest-free banking have been criticized by religious scholars for their not being consistent with the spirit of *shariah*[7]. The author of the book under review has rightly drawn attention to the objectionable features of these banking practices (pp. 46-47) but he is wrong in his assertion that "Islamic economists as a body in their International Monetary and Fiscal Conference held in Islamabad in 1981 gave their unreserved approval to this arrangement" (p. 48). The fact is that the Islamic economists gathered at that Conference complimented the Government of Pakistan and the Council of Islamic Ideology for the intensive work done to find ways and means of eliminating *riba* and commended the Report of the Council as a historic document, but they had no opportunity to look into the actual operating procedures of banks and did not therefore express any opinion on such procedures[8].

In the second chapter of the book, the author puts forward his own model of an interest-free banking structure. He builds his model on the premise that "time is as much an ingredient of a loan as the loan itself". He explains this further by stating that "what the lender foregoes and the borrower receives is not merely an amount of loan but an amount of loan for a certain period of time". He then sets forth a hypothesis: "If we multiply the amount of loan by the period for which it is advanced, we get the measure of deprivation suffered by the lender which is also the measure of gain received by the borrower". He gives this magnitude the name of "loan value". He then proposes the establishment of an interest-free banking system on the principle of equality of "loan values". Specifically, what the proposal amounts to is that if a person needs loan for any purpose from a bank for a certain period of time he should also give loan to that bank in an amount such that the "values" of the two loans are equal. For example, if a person needs a loan of Rs. 1,000 for one year he should give a loan of, say, Rs. 100 for ten years to the bank. At the expiry of the stated period both parties will repay their loans in original. This is the essence of what the author calls Time-Multiple Counter-Loan (TMCL) based interest-free banking. The third chapter of the book discusses the modalities of a change over from interest based banking to TMCL model of interest-free banking. In the final chapter the author seeks to answer possible objections to his model.

The author is aware that availability of bank loans at zero rate of interest, as postulated in his model, will result in a steep rise in the demand for bank loans. He proposes to meet this situation by the abolition of statutory reserve requirement which he considers an unnecessary restraint on the credit creating capacity of the banking system. He concedes that even this may not enable the banks to meet the full demand for bank credit. So he proposes that banks should not grant any loans for non-productive purposes and should also not advance any loans for covering the budgetary deficit of the

(7) See, in this connection, the chapter on "Islamization of the Economy" in Government of Pakistan, (1985), esp. pp. 10-11.

(8) See the communique issued at the end of the Conference of Islamic Economists in **Ziauddin Ahmad**, *et al.* (eds.) (1983), pp. 365-67.

government. Besides, they will be able to borrow from the central bank of the country to meet the additional demand for bank on the same TMCL principle. In suggesting such solutions to the problem that may arise consequent to the adoption of his model, the author seems to be oblivious of the danger of excessive credit expansion by banks. The author seems to believe that there is no danger of undue inflation being caused by credit creation as the monetary demand generated by credit creation will be absorbed by the increase in production both on account of full utilization of the previously existing idle capacity and increments to the productive capacity of the economy. This is obviously a highly over-simplified approach to a very complex question. The argument employed by the author assumes that there is an unlimited supply of real capital available in the economy. The fact of the matter, however, is that most countries, and particularly the developing countries, face a big problem of shortage of real capital. This shortage of real capital cannot be remedied by credit creation because bank credit only gives command over real resources; it cannot create real resources. Once it is realized that the capacity of an economy to produce goods and services is constrained by the availability of real resources, which in turn is dependent on a host of factors such as the saving rate of the economy and availability of foreign exchange, one has to admit that unrestricted availability of bank credit at zero rate of interest can pose a serious threat of inflation to an economy which adopts TMCL model of interest-free banking.

It should of course be possible even in a TMCL model of banking to guard against inflation by imposing a limit on overall credit expansion through central banking action. However, once the need for keeping credit expansion within certain limits is recognized, the question of the optimality of various options available assumes importance. In the interest-based system, the equilibrium between the demand for and supply of loanable funds is sought to be achieved by variations in interest rates. Writers on Islamic banking have shown that replacement of interest by a system of profit/loss sharing is a more efficient way of bringing about a balance between the demand for and supply of bank funds. The argument essentially is that in the interest-based system there is no inbuilt incentive on the part of banks to give priority to ventures with the highest profit potential, while in a system based on profit/loss sharing resources are likely to flow to most profitable ventures which is a plus factor for allocative efficiency. The TMCL model also, like the interest-based system, will be concerned more with the safety of the funds lent rather than the profit potential of ventures, and is thus open to the same criticism as the interest-based system from the viewpoint of allocative efficiency.

From the viewpoint of equity, the TMCL model can hardly qualify as a serious alternative to interest-based banking in an Islamic economy. Islamic banking is expected to not only avoid transactions on the basis of interest, but also to participate actively in achieving the goals and objectives of an Islamic economy. Reduction in inequalities of income and wealth figures as an important policy objective in an Islamic economy. The TMCL model, instead of being of any help in this respect, will in fact serve to aggravate inequalities of income and wealth. Depositors in the TMCL model would get no return on their deposits while borrowers will not have to part with any part of their profits. A large number of depositors belong to lower income groups, including the weakest sections of the population such as retired people and widows, while borrowers are mostly businessmen belonging to the most affluent sections of the population. Replacement of interest-based banking by TMCL model of interest-free

banking would further enrich the richer sections of the population and penalize the weaker sections of the society and aggravate the maldistribution of incomes and wealth.

It is well known that while any return on capital in the form of interest is prohibited in Islam, there is no objection to getting a return on capital under profit/loss sharing arrangements approved by *shariah*. There is no reason why the author should be opposed to giving any return to the depositors in an Islamic banking system even though they are prepared to take the risk of a loss in capital. It is really strange that while the TMCL model of interest-free banking presented by the author envisages banks earning "profit exceeding even those that present pattern of banking can yield" by "direct productive investment" of funds (p.85) accruing to the banks through counter-loans and credit creation, it denies any return to depositors who in fact enable the bank to earn such high profits. In fact, the TMCL model richly rewards a small band of shareholders of the bank and leaves the large body of depositors high and dry!.

For guarding the stability of the banking system under his proposal, the author suggests that "a collateral of 110 percent of the loan should be demanded for all loans" (p.59). The author does not seem to be concerned with the distributional implications of such an arrangement. Other writers on interest-free banking emphasize that it must be one of the foremost objectives of an Islamic banking system to get rid of the collateral syndrome. It is due to the insistence on the collateral that financing by interest-based banks gets directed mainly to the rich. Banks in an Islamic economy are expected to help in achieving the Islamic socio-economic objective of providing equal opportunities for material advancement to all sections of the population. This requires Islamic banks not to be guided by the collateral but by the soundness of the business propositions in their financing operations. The TMCL model of interest-free banking presented by the author seeks to eliminate interest from banking transactions but, by continuing emphasis on the collateral, retains one of the most objectionable features of interest-based banking from the Islamic viewpoint.

The book contains a number of highly oversimplified and unsubstantiated statements. The author attributes economic success of Switzerland and Germany to lower bank rate (p.17). He does this without examining the possibility that lower bank rate may in fact have been a consequence of the success achieved by these countries in avoiding high budgetary deficits and maintaining a strong balance of payments position. He claims that TMCL model of interest-free banking has a "built-in arrangement to help any economy to outgrow both unemployment and inflation" (p.83). The arguments employed to prove this claim are hardly convincing. The author seems to believe that elimination of interest will bring about such an increase in investment that the labour force will be fully employed. This line of argument disregards the objective realities that investment may not be sufficiently interest elastic in many situations, particularly in situations of shortage of real capital and absence of sufficient wage price flexibility.

Is TMCL model of interest-free banking compatible with *shari'ah*? This is a debatable issue. The author claims that TMCL model is institutionalization of *qard hasan* and "there is no doubt about the permissibility of the concept from the Islamic point of view" (p.135). However, as the author himself notes, reservations have been expressed about the counter-loan aspect of the TMCL concept by Islamic scholars.

The author claims that "the TMCL concept can be regarded the only viable, workable and feasible substitute for interest" (p.87). This is an unjustified statement. Experience has shown that Islamic banks have to employ a variety of financing mechanisms to operationalize the concept of interest-free banking.

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