JKAU: Islamic Econ., **Vol. 1**, pp. 119-120 (1409 A.H./1989 A.D.)

Volker Nienhaus

Profitability of Islamic PLS Banks Competing With Interest Banks: Problems and Prospects

JRIE, Vol. **1**, No.**1**, Summer 1403 (1983)

Comments: Shahrukh Rafi Khan
Pakistan Institute of Development Economics
Islamabad, Pakistan

Dr. Nienhaus has with a straightforward analytical method sought to provide an insight into the functioning of Islamic banks (using PLS as the only financial instrument) in competition with interest-based banks. While the lucidity of the analysis is laudable, I have some reservations about the general approach and specific analysis. Dr. Nienhaus' assertion that the model of the wholesale transformation of an Islamic system discussed by Islamic economists is irrelevant in practice is not completely accurate. Currently Iran and Pakistan provide counter examples to this statement. It needs to be pointed out that after having criticised Islamic economics theorising for its lack of realism, Dr. Nienhaus goes on to assume, for ease of analysis, that PLS is the only financial instrument used by Islamic banks when competing with interest-based banks. Empirically, hire purchase, leasing and mark-up may be the more popular financial instruments currently in use. Nonetheless, I find the assumption acceptable because from a normative perspective PLS may be the closest to the Islamic ideal.

On the specific analytical approach I have one major objection which perhaps undermines a good part of the analysis. Dr. Nienhaus starts out with various definitions among which is the following:

$p^{PLS} = p^{int} + CI$. (equation 3).

Where p^{PLS} = the profit as defined in the PLS system
p^{int} = the usual profit

Cl = the interest costs which are calculated as the multiplication of the amount of capital employed in the investment, X, with the market rate of interest for loan capital, i.

Given this, and introducing expectations into the simple model, a few simple algebraic manipulations reveal that if realised profits do not satisfy expectations, the revenues of the Islamic PLS banks will be smaller than the revenues of a comparable interest-based bank (p.43). This result critically hinges on accepting the basic premise the analysis starts out with (i.e. equation 3 quoted above). The assumption implicit in equation 3 is that Islamic banks on average will face the same portfolio of liabilities as will an interest-based bank. Whether this is true is an empirical question. It is likely that an Islamic bank will draw clients with low collateral needing funding for high risk, high profit projects. Thus it is possible that on average.

$$p^{PLS} > p^{int} + CI.$$

Risk of course would have to be explicitly built into the analysis. Even if the composition of investment projects were identical for Islamic and Interest banks, one would expect Islamic banks to have adequate appraisal capacity, so that they don't have to rely on simplistically discounting the stated expected profits of their clients as the insight from Dr. Nienhaus' analysis suggests may happen (p.44).

Finally, one prescription of the analysis may need qualification. Promoting a partnership of Islamic banks with innovative European enterprises with low chances of securing financing from the home capital market could be mutually beneficial (pp. 46-47). However, I am less comfortable with the idea of using such links to generate imports to the home country than for technology transfer, by using the financing as a vehicle for linking the foreign enterprise to an innovative entrepreneur in the home country.