CHAPTER THREE

Some Conceptual and Practical Aspects of Interest-Free Banking

*Dr. Muhammad Uzair**

BANKING is an important financial intermediary and vital institution in the economic structure of any country. It mobilises savings and idle funds in an economy and makes them available to those who can make better and fuller use of them. In this way, banking effects a re-allocation of the capital funds. Besides this main function, the banking system makes possible a most convenient method of making payments through chequing facilities, and renders many other subsidiary services. An important question that agitates the minds of those who think on Islamic economics, whether proponents or critics, is the feasibility of interest-free banking. It is proposed to discuss here, briefly, certain conceptual and practical aspects of the issue.

At the very outset it is desirable to lay down the axioms or assumptions for the following discussion. The first axiom is that interest in all its forms is prohibited by the Holy Qur'ān. This also implies that there is no room or justification to introduce various interpretations on the term *Ribā* as has been attempted by some scholars. The second axiom is that the Muslim society in an Islamic State is genuinely interested in eliminating *Ribā* and sincerely desires to introduce a system of interest-free banking, not as a supplement to, but as a substitute for the prevalent system of banking. This means that the members of the society and the State are not only interested in making the change, but are prepared to bear the inconvenience and the difficulties that would be unavoidable in the transitionary phase of the changeover. These two axioms have been mentioned in the beginning because it is not only a scientific system of analysis and writing according to research techniques, but is also the approach of the Holy Qur'ān itself.

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*Dr. Muhammad Uzair, Consultant, Investment Corporation of Pakistan, is amongst the pioneers of *Ribā*-free banking. He has also served as Professor of Economics, University of Karachi; Director, Institute of Business Administration, Karachi; and Member, Monopoly Commission, Govt. of Pakistan.

In the very beginning of the Holy Book, preconditions have been laid down regarding the people who are likely to benefit from the guidance, from the code of life, given in the Qur'ān.

I. Redefining the Factors of Production

In the light of the above-mentioned axioms, let us now look at the need to modify the conceptual framework of economics to suit the requirements of Islamic economics. The beginning will have to be made by redefining the factors of production.

A postulate which is essential for the analytical framework of Islamic economics is that capital as a separate factor of production does not exist, but is a part of another factor of production, namely enterprise. This means in essence redefining the term "enterprise" in a broader way so as to include "capital" as a part thereof. This, it may be mentioned, is not difficult to reconcile. With the passage of time and technological changes in methods of production, the definitions of other factors of production have also gone through changes. Land, for example, does not mean land in the limited sense any more, but for all practical purposes land today is synonymous with the term "natural resources". Similarly, the term "labour" has become wider, to include not only the industrial worker in the limited sense, but white-collared personnel, as well as the managerial personnel in any productive unit. Thus, for all practical purposes the term "labour" now denotes all "human resources". Moreover, considering the modern methods of production, along with an assessment of the qualitative process of production, suggests the need for considering technology as an important factor of production. Technology plays its role whenever there is a relationship between natural resources and human resources. The production resulting from a combination of natural and human resources is also determined by technology. It needs no proof or effort to establish that, given the same inputs of natural and human resources the quality of the "enterprise" factor and the quality of the "technology" factor will lead to different outputs in two productivity units, or indeed in two different countries. In the text books of economics one finds that whenever there is a discussion of economic laws, such as the law of diminishing marginal utility or the law of diminishing marginal returns, a qualification is mentioned that the quality of the commodities and the inputs respectively remain the same or unchanged. However, in practical life we find that except in a very primitive society things do not remain the same and the qualities of commodities or inputs invariably change over a reasonable span of time. This in other words means that in the present day, technology has become such an important factor that the quality of products and the quality of the natural resources, as well as the quality of the human resources applied, always change with the passage of time, except perhaps in a very short run or at one point of time in a limited sense. The importance of technology thus has to be recognised as a factor of production and assuming that this factor remains constant means laying down an assumption which is not relevant to the facts of practical life.

The postulate of combining capital with enterprise is conceptually not too difficult to reconcile. The definition of the term "interest" in the economic literature has already been broken down into two parts on a conceptual level. A distinction has been made between the return on the capital, and the "risk premium" to take care of the risk or uncertainties in recovery and other things. This distinction implies that conceptually speaking interest and profit have some resemblance, in that interest includes reward for risk while profit constitutes a reward for uncertainty. This, in other words, means some resemblance between capital and enterprise. Moreover, the formation of large corporations and companies with a large number of shareholders – sometimes more than a million – and the institution of raising share capital of joint stock companies from the general public have tended to combine the functions of enterprise and capital in the same persons. Entrepreneurs, therefore, are not only the small number of promoters who conceive and initiate a particular project but also the large number of shareholders who join the sponsors or promoters and also become entrepreneurs. All that these large number of entrepreneurs are doing is to provide capital, or more precisely "risk capital" and agreeing to accept the return or profit on their investment which is not predetermined but has some uncertainty regarding the rate of dividend likely to be declared, and be mentally prepared for the extreme possibility of not receiving any dividends if the performance of the company or the project is not nearly as satisfactory and fruitful as was anticipated by the people who subscribed to the share capital.

With the passage of time the concept or definition of a bank has also undergone many changes. The modern-day banks are no longer operating on the classical lines of commercial banking, namely short term loans of 90 days in the nature of "self-liquidating" loans or bills. The classical concept of a commercial bank as providing only short term capital for three months has undergone changes. The modern banks, not only in developed countries but also in developing countries, are engaging themselves in a big way in financing industries and agriculture. This financing, moreover, is not confined to short term capital but includes credit facilities to help in acquisition of fixed assets for intermediate terms as well as long terms of maturity. Thus, the distinction between commercial banks and development banks is fast disappearing because of the structural changes in the economic activities of most of the countries. Commerce is no longer the most important sector for the banks. The relative importance of this sector has declined in all countries, including the developing countries. Similarly, the investment operations regarding the earning assets of the banks have increased. Investments by banks are not confined to short term treasury bills or even long term government bonds bearing interest. Commercial banks have started making investments in the equity shares of enterprises, so enabling the banks to collect dividends on those shares. Thus, it will be noticed that the water-tight compartmentalisation of commercial banks and investment banks is also disappearing gradually. In brief the commercial banks are moving from purely commercial banking to development and investment banking, thus getting used to examining carefully the profitability of the projects or the scripts in which they use their funds. Scientific financial and credit analysis are in practice in all the good banks. Thus, the banks should not find it difficult from a practical point of view to shift from interest-earning bodies to profit-sharing or dividend-receiving bodies.

II. Flaws in the Theory of Interest

The theory of interest has always been a very difficult area in economic literature. The application of a marginal productivity approach has not been found to be very helpful in the case of interest. Complex explanations have been attempted to explain the rationale of charging interest, the rate of interest and the supply of capital funds. Some of the explanations which have been given are: (a) Time Preference Theory, (b) Abstinence Theory, and (c) Liquidity Preference Theory.

The most formidable treatment of the theory of interest has been given by Austrian economist Bohm-Bawerk. He tried to explain the rationale of interest and the rate of interest in terms of time preference, namely the concept of technical superiority of present over future. This implies that an average person prefers present over future and if he is required to forego the present comfort or use of his funds, he is entitled to some remuneration known as interest. However, the explanation of capital formation is rooted in the "roundaboutness" of the method of production.

This complex concept takes us to a primitive society, and an explanation of capital is given in terms of "physical capital" formation, or to be more exact, accumulation of "capital goods". Naturally, an explanation of the origin of accumulation of capital goods cannot be used to explain capital formation and allied rationale for charging interest in a period when cash capital or "capital funds" are used. Moreover, Bohm-Bawerk – who tried to offer a counter-thesis to the concept of Karl Marx – by emphasising the roundaboutness of production ends up with an explanation of capital formation in terms of primitive capital which in turn brings his thesis very near to the labour theory of value expounded by Marx.

Similarly, the concept of abstinence given by some other thinkers is untenable in the present society. In the practical life of today, we do not see any abstinence on the part of those who provide the bulk of the savings or the capital funds. This can perhaps be possible in a very primitive society where the government may force the people to save, thus causing an abstinence or sacrifice on the part of those who save, providing capital funds, thus entitling them to a reward for the abstinence or the sacrifice in the form of an interest payment. The concept of "forced saving" of the modern variation is even less applicable in the case of a saving process making available the capital funds and justifying the payment of interest thereon.

The Keynesian concept of "liquidity preference" as a justification or rationale of interest on the supply side is accompanied by a concept of marginal efficiency of capital on the demand side. In the Keynesian framework these two concepts determine the rate of interest. The determination of interest by liquidity preference is not exactly the same thing as determination of interest by supply of savings or investible funds. However, doubt has been expressed about the validity of this explanation. It has not been established whether the supply of liquid funds or savings in general are determined by the rate of interest, though they may be partially affected by that phenomenon.[1] Thus we find that economists have been hard put to explain the rationale of interest and the rate of interest.

Perhaps the theory of interest is the least clear part of the entire economic theory. This is so because an effort has been made to explain something which is difficult to justify. Those who have tried to give some rationale, taking into account and criticising other theories and explanations had ultimately to use the concept of opportunity cost. The rate of interest according to them consists of three parts: (a) the basic interest rate, (b) a risk premium, and (c) administrative costs involved in the lending process. The combination of the first two components, namely the basic rate and the risk premium constitute the opportunity cost.[2] However, no valid and sound explanation has been given regarding the basic rate itself. The basic or the minimum rate has been taken as the rate of interest charged by the government on their securities which have practically no risk of non-recovery.

The basic rate of interest or the opportunity cost has been identified as the government rate of interest on its securities wherein no risk is involved. This is hardly a satisfactory conceptual explanation. This rate paid by the government is an arbitrary decision, and a constant rather than a variable explained in the normal economic powers.

Another practical difficulty in explaining the rationale of interest and its rate is the fact that capital funds actually used for investment purposes come from different sources. On an *ex post facto* basis the total investment and the total saving are supposed to be equal not only in the Keynesian framework but also in the analysis of those who partially differ with Keynes. However, on *ex ante* basis the investment and savings may not be equal according to the economists. The difference is because of the fact that investment is supposed to be the function of the entrepreneur, while saving the supply of capital is the function of the capitalist or the saver.

For the economy as a whole, though, what really matters is investment or the saving actually used. Thus the real thing of significance is the capital funds. The courses of supply of capital funds in the present-day economy are various:

(a) The most important source for the supply of capital in modern industrialised society is the "retained earnings" or the reserves built by various productive units. In many advanced countries, the retained earnings constitute more than half of the additional funds required. This portion of available capital funds naturally is not determined by the rate of interest but is a function of other variables such as possible uses and expected rate of return on the investible funds accumulated in the form of retained earnings by the corporations and companies.
(b) Capital funds made available and used in the form of equity investment, namely new investment in shares issued by various productive units or companies. At present, with joint stock companies as the typical form of business ownership and organisation, an important and significant part of total capital funds, and utilisation of savings of the people, takes this shape.
(c) Capital funds available in the form of lending on the basis of interest. This shape or form of savings may be used in government securities, debentures or bonds of the private sector, and deposits in the banks.

Looking at these three alternative sources of supply of capital funds one is bound to realise that at present, two out of these three alternative sources of capital funds originate without any consideration of interest. One finds that the bulk of the total capital funds take the shape of equity investment in one form or the other. This development, therefore, leads us to justify the merging of the two factors of production, namely enterprise and capital into one single factor. Thus consequent elimination of interest as a form of reward for capital is justified for two reasons: Firstly, that conceptually a sound and correct explanation of interest as a remuneration has not been possible by the economists who have thought little on the subject. Secondly, looking at the practical operation of the present-day economy we know that the sharp line of distinction between capital as a factor of production, and enterprise as a factor of production, is not tenable, as it would be in a primitive society where everything can be explained in terms of labour theory, as done by Karl Marx.

Under the present analytical framework of modern economic theory capital is a factor of production entirely different from all other factors of production. The differences between the characteristics of capital and other factors are:

(a) Unlike other factors of production, capital is itself the result of production, or a produced means of production. This does not apply to other factors like land, labour and enterprise.
(b) The origin of capital, and the accompanying justification for its remuneration, are derived from the accumulation of physical capital or capital goods in a primitive society. However, the same justification for reward or remuneration is applied to cash capital or capital funds. This is a unique treatment and creates confusion.
(c) Factors of production other than capital lose some degree of productivity and utility with the passage of time. While other factors of production wear out or depreciate with usage, capital in the sense of "cash capital" as different from "physical capital" does not wear out or lose its value over time.
(d) While in the case of other factors of production, there is always some unavoidable difference in quality between one unit and the other units, capital in the sense of "cash capital" is of uniform quality as far as various units are concerned.

These differences between capital and other factors of production naturally raise a question as to whether the capital is a factor of production at all, or is it only a tool or means for another factor of production, namely enterprise. It is known that pre-enterprise in the sense of enterprise without having some capital along with it, does not exist in practical life. This means that there are capital funds available in two forms and in two manners, namely capital which goes automatically with enterprise, usually known as the "risk capital", and the pure capital or credit which is available at a certain rate of interest. Logically, therefore, capital should be merged with the other factor of production known as enterprise.

The separation of enterprise and capital has created not only conceptual problems but has caused practical problems in the operation of the economy. According to monetary theories of trade cycles, most of the cyclical fluctuations have resulted from an over-investment or under-investment of "cash capital" in the economy. The lack of synchronisation between saving and investment on *ex ante* basis has created the problems. Through the borrowed capital, which has no relationship with the voluntary saving, there is always the possibility of over-expansion resulting in lack of synchronisation between saving and investment. Hayek, a leading proponent of the monetary theory of trade cycles, points out:[3]

> "Nobody has ever asked them to pursue a policy other than that which, as we have seen, gives rise to cyclical fluctuations; and 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 organisation of credit. So long as we make use of bank credit as a means of furthering economic development, we shall have to put

> up with the resulting trade cycles. They are in a sense the price we pay for a speed of development exceeding that which people voluntarily make possible through their savings and which, therefore has to be extorted from them."

Thus, if capital is merged with the factor of enterprise, over-expectations and, therefore, over-expansion of credit can be eliminated. The defects of the banking system on a credit basis, pointed out by Hayek, can be overcome if the banking business is reorganised in such a manner that capital and enterprise move together. If there is this merger of capital with enterprise, the possibilities of over-expansion of credit will also be eliminated. This means that all capital becomes "risk capital", or a part of enterprise. The decisions of the members of entrepreneural groups will then not be in a vacuum and on a presumption that bank credit will be available on a contractual basis and at a rate of interest which is substantially lower than the rate of profit. If banking business is reorganised in such a manner that the depositors interested in earning some income on their deposits are required to share the profit and loss with the users of the capital funds or the entrepreneurs, a better equilibrium will emerge and a more harmonious relationship between *ex ante* savings and investment will be possible.

III. Basis of Interest-Free Banking in an Islamic Framework

We have seen earlier that capital is an instrument of enterprise both from a conceptual point of view and from a practical point of view. We will now have a look at the conceptual basis of interest-free banking in the framework of Islamic tenets. As mentioned in the beginning, we start from an axiom or assumption that "interest" as a form of payment for use of capital funds is prohibited. The Holy Qur'ān ordains the prohibition of "interest" (*Ribā*) at least five times in the second *Sūrah*. This prohibition of interest has been put as (i) Madness (*Takhabbuṭ*), (ii) a thing God wants to "destroy" (*Maḥq*), (iii) a thing which if not abandoned deserves a "war" (*Ḥarb*) from God, (iv) a thing which is anti-thesis of faith (*Īmān*) or in other words infidelity (*Kufr*), and (v) a thing if persisted in which calls for permanent abode in hell (*Khulūd fin-Nār*). These aspects of *Ribā*, as it is looked upon in the Qur'ān,[4] have been mentioned only as examples.

As interest is prohibited for all purposes and in all its forms as far as the Islamic framework of thought is concerned, we have to look for guidance for a system of banking which is in consonance with Islam. The conceptual basis for a better banking system even according to general economic theory would be the one wherein capital is a part or partner or instrument of the factor of production known as enterprise. Thus, we have to look in Islamic literature for a permissible form of business relationship between those who provide capital funds and those who use the same, on the basis of sharing profit or loss as the case may be. In this connection we find a mention of the institution of *Muḍārabah* or *Qirāḍ* or *Muqāraḍah*. According to a great Muslim jurist, Imām Sarakhsī, the definition of the institution of *Muḍārabah* based on the Qur'ān and the *Sunnah* is as follows.[5]

" املاء المضاربة مشتقة من الضّرب فى الأرض وانما سمى به الآن المضارب يستحق الربح
بسعيه وعمله نحو شريكه فى الربح ورأس المال الضرب فى الأرض والتصرف وأهل
المدينة يسمون هذا العقد مقارضة ذلك مروى عن عثمان بن عفان رضى الله عنه
فانه دفع الى رجل مالا مقارضة وهو مشتق من القرض وهو القطع فصاحب المال قطع
هذا القدر من المال عن تصرفه وجعل التصريف فيه الى العامل بهذا العقد فسمى به
ويضربون فى الأرض يبتغون من فضل الله " .

Translation: "The word *Muḍārabah* is derived from "*Ḍarb* on Earth". It has been so named because the *Muḍārib* (user of others' capital) qualifies to get a share of the profit on account of his endeavours and work. He thus participates in the profit as well as having the right to use capital, and strive according to his discretion. People of Madinah call this contract *Muqāraḍah* which is derived from the word *Qarḍ*, meaning "surrendering". The owner of capital, thus, surrenders his own rights over that portion of capital, to the *Āmil* (user of capital). This is how it has been so named. We have, however, chosen the former name as it conforms to what occurs in the Book of Allah saying 'and others strive on earth seeking the gift of God' . . . "

The legality of this kind of partnership between the supplier of capital and user of capital is also recognised by other jurists of Islam such as Burhānud-Dīn 'Alī b. Abū Bakr al-Marghīnānī (in his work *Hidāyah*) and 'Alā'ud-Dīn Abū Bakr b. Mas'ūd al-Kāsānī (in his work *Al-Badā'i' was-Sanā'i' fī Tartīb ash-Sharā'i'*). Actually the institution is one of those that prevailed in Arabia before Islam, but was found to conform with the Islamic principles and was thus retained in the Islamic framework. Ibn Rushd says about *Muḍārabah:*[6]

" ولا خلاف بين المسلمين فى جوانى القراض وانه مما كان فى الجاهلية فأقره الاسلام
وأجمعوا على أن صفته أن يعطى الرجل المال على أن يجريه على جزء معلوم
يأخذه العامل من ربح المال أى جزء كان مما يتفقان عليه ثلثا أو ربعا أو نصفا . "

Translation: "And there is no difference of opinion among the Muslims about the legality of *Qirāḍ*. It was an institution in the pre-Islamic period and Islam confirmed it. They all agree that its form is that a person gives to another person some capital that he uses in

> business. The user gets, according to conditions, some specified proportion of the profit, i.e. any proportion they agree, one third, one fourth or even one half."

The two above-mentioned extracts from leading jurists of Islam indicate the legality of a partnership between the saver, or the supplier of the savings, and the user of the savings or the investors. Before we proceed further it may be mentioned that the term "user of capital" as used in the above quotations does not mean only physical worker or labourer in the limited sense but would include entrepreneur or the person who uses the investable fund according to his abilities, experience, and expertise. This difference between society of that particular type and the present-day business framework explains the reason why the user of capital would now include the entrepreneur rather than workers or labourers alone. Moreover, even in those days some of the users of capital were not workers or labourers in the limited sense but were businessmen who used the capital for actual investment purposes. Thus the contract or the arrangement of *Muḍārabah* or *Muqāraḍah* is actually an arrangement of partnership or profit sharing between the supplier of capital and the user of capital who work together as partners and share the profit or loss as the case may be. This is in brief the foundation of partnership between capital and enterprise in the Islamic framework.

We have now to apply the above-mentioned principles of partnership between capital and enterprise in the field of banking. It may be mentioned that in the case of interest-free banking in an Islamic Society there will be three parties: (1) The actual user of capital or entrepreneur; (2) The bank which serves as a partial user of the capital funds and as an intermediary link; and (3) The supplier of savings or capital funds, i.e. depositors in the bank. Thus, there is a triangular relationship between the actual entrepreneurs, the banks, and the depositors. One tier of *Muḍārabah* partnership will be between the depositors and the bank; and the other tier will be between the bank and the ultimate or actual user of the fund or the entrepreneur. There may be for example an arrangement that the entrepreneur (or the borrower in the present-day banking system) and the bank would share the profit in a ratio of 50 per cent each, or 60 per cent for the entrepreneur and 40 per cent for the bank, or any such ratio which may be agreed upon between themselves may be regulated by the government or the central bank. Similarly, there will be an arrangement between the bank and the supplier of capital (depositors in the present banking system) for sharing the profit in the ratio of 50 per cent each or 60 per cent for the bank and 40 per cent for the supplier of capital funds or the depositors. This may seem at first sight to be a complex arrangement, but once the system is introduced and begins to operate in practical life, it will become as mechanical and routine as the present-day system wherein banks charge a higher rate of interest on certain categories of deposit while paying nothing to some types of depositors, e.g. the Current Account depositors. The source of profit for the bank is the difference between the interest it receives and the interest it has to pay to the depositors. Similarly, in the changed framework required for interest-free banking, the entrepreneurs and the bank would share the profit on an agreed percentage or ratio, a higher proportion going to the entrepreneur *vis-à-vis* the banks; and the depositors would share a smaller proportion of what comes to the bank. Variation in ratios may reflect different tiers of the system.

Whether percentage or the ratio for sharing the profit between the entrepreneurs (borrowers) and the banks on the one hand, and that between the banks and the depositors on the other, should be determined in the normal course of business activities and bargaining or should be regulated by the government or central bank as a policy variable or a political decision by the government either arrangement would serve the purpose as far as the conceptual framework is concerned. The decision will have to be taken in the light of the actual circumstances prevailing and the inclination of the people who make the decision. On the face of it, it may seem that a ratio of two thirds for the users (65 per cent) and one third for the suppliers (35 per cent) would seem to be a reasonable arrangement because this would be a good via media. In the extract given, one extreme being the 50 per cent for each party, and the other extreme being one quarter for the supplier and threequarters for the user of capital. However, the central bank of the country can be empowered to introduce slight modifications in the details of the terms and conditions from time to time, depending upon the overall economic situation and the expansionary or contractionary policy pursued by the central bank in the interest of the overall national economic well-being of the country. This power would be analogous to the power to change the "bank rate" in the present system.

The above arrangement would take care of the main profit-earning activity of the banks in an interest-free banking system. To be more precise, the arrangement pertains to what could be described as the "investment account" deposits in the banks. As far as the demand deposits or the demand liabilities are concerned, the matter is simpler as will be discussed a little later. Similarly, subsidiary services or the activities of the banks will remain unaffected. These subsidiary services which are not the main profit-earning activities from the point of view of the banks themselves, constitute an important service for the clients of the banks. The subsidiary services are: remittance facilities, safe vault arrangements and many other relatively smaller services. The real question regarding the feasibility of the interest-free banking system relates to the main profit-earning activities of the bank, namely the loans made available to the industrial and business sectors for whom the bank finance constitutes an important activity. This main business of banking we have already analysed above.

We will now turn to discuss the operational aspects of interest-free banking.

IV. Structure of Banking Business

Having discussed the basis and character of long-term loans in Islamic banking we have to analyse the practical structure of banking operations in interest-free banking. In this connection let us first discuss briefly the deposits of various categories in a commercial bank under any system, and then see how things would stand in an interest-free banking system. The analysis will be based on an approach of sources and uses of funds, namely inflow of deposits and the generation of earning assets therefrom. In the analysis of deposit types, we can also use the Keynesian approach of "motives" of "liquidity preference" and savings. The deposits in commercial banks are of three broad categories, namely: (a) Fixed Deposits or Time Deposits, (b) Savings Bank Account Deposits, and (c) Current Account Deposits. The motives of the deposits and depositors in the three categories are different.

The motives of the depositors in the first category, namely fixed deposits, is "investment motive" or "finance motive", that is to earn on the idle funds some income during the period that they themselves do not utilise those funds in their normal business operations. In the changed framework of banking the deposits in the Fixed Deposits or Time Deposits category will become "Investment Deposits". These deposits will be invested by the banks by making these funds available to the parties who need these investment funds to generate and earn income thereon. These investment funds or loans would constitute the main earning activity of banks in interest-free banking. In case of excess demand for loans, part of the funds can be obtained from the next category of deposits, as we will discuss in the next paragraph. However, in case of even more demand, the bank can resort to borrowing from the central banks as is done at present. Needless to say the availability of the funds from this source will depend on the monetary policy of the central bank, which is quite understandable. The profit or dividend earned on these funds can be utilised by the banks for distribution among the "investment depositors". The income or dividend earned from these funds can be credited on a pro-rata basis to the depositors in this category.

The second category of deposits, namely the Savings Bank Account category is also motivated by the desire to save some funds and to earn some income. The main difference between Fixed Deposits and Savings Bank Deposits is the nature and kind of depositions. The Fixed Deposits are the deposits by the business community and other sections of the population which are well off and have idle funds for which they themselves cannot think of a direct investment, either because of lack of information about opportunities or because of lack of initiative and a desire to avoid taking any risks. The primary motive is "investment motive" or "finance motive" while the secondary motive may be "precautionary motive". The depositors in the Savings Bank category on the other hand are people in the middle class and the motive of these depositors is saving for a primarily "precautionary motive" while the secondary motive may be "investment motive" or "finance motive". The people in this category prefer to deposit in a Savings Bank Account instead of a Current Account because their motive may be to earn a little income on it during the period that these funds are deposited with the banks. The banks invest these funds by giving loans to other parties or by buying some securities of either the public or private sector. In the changed framework the banks can invest these funds as they do now and credit the income thus earned to the accounts of depositors on a pro-rata basis.

The third category of deposits, namely the Current Account Deposits are owned by different sections of the population with primarily the "transaction motive" of keeping the excess liquidity readily available so that the depositors can write cheques on these accounts, thus finding a convenient method of spending and making payments. Since the motive of the depositors in this category is not to earn any profit or income, the banks generally do not and need not pay any return on this category of deposits. In the changed framework the funds available with the banks in this category will not be invested for making loans or investment and other securities. However, the banks can use this short term excess liquidity of the depositors to make very short-term loans to the parties which run out of liquidity because of unavoidable problems in cash management and lack of synchronisation between inflow and outflow of cash resources. Thus, the funds in this category do not require the banks to make any payment of profit or dividends to the depositors. In fact the modern banks in many countries realise moderate "service charges" besides the cost of the cheque books, from the depositors in this Current Account or Chequing Account. The rationale for this charge, besides recovery of unavoidable costs, is that the banks make available the convenient service of making payments, enjoyed by the depositors in this category. Logically, therefore, the very short-term loans made out of the funds in this category do not entitle the banks to charge anything from the parties which borrow for very short term purposes to balance the liquidity position rather than to make investment in profitable ventures.

This treatment of the Current Account Deposits solves the fundamental problem which arises in the minds of people with regard to interest-free banking. The banks will not charge anything on the loans made out of the funds in this category of deposit. However, the banks can recover from the clients a moderate amount as service charges to take care of the cost which is incurred in making book-keeping entries and such other activities which are unavoidable in the process of making short-term loans.

If, however, the banks still have some excess liquidity – after taking into consideration the cash resources and compulsory liquidity required by the central bank – they can make use of the funds in this category for holding near cash items like government treasury bills, of course without interest. Even in the present situation the interest on treasury bills is very nominal, and a changeover from the present system to the interest-free banking system will not involve any serious problem. Inter-bank lending on a short term can also be made out of the excess liquidity in this category of deposits.

In the light of the above picture of the structure of banking without interest, the financial viability and operational feasibility can be seen clearly. With the help of this outline a Balance Sheet (or position statement) and a Profit and Loss Account (or Income Statement) can be easily drawn up to show that the banking operations can be as smooth and profitable in an interest-free system as in the present one. The discussion, it is hoped, would be convincing not only for economists but also for the practical bankers.

V. Some unresolved Practical Problems

After discussing the overall structure of banking, let us look, in greater detail, at some practical problems which agitate the minds of students and critics of interest-free banking.

(a) Short-Term Credit

An important unresolved question in the literature on interest-free banking is that of very short-term loans. We know for a fact that in spite of the structural changes that have taken place in the banking business, an important segment of its activities is the provision of short-term loans or overdrafts. Sometimes these short-term loans may be for a period of much less than three months or the classical 90 days transactions.

A genuine question arises as to how can the banks be rewarded or remunerated for these short-term loans for which the determination of profits is impracticable and even irrelevant. It has been argued by some writers that this should be a free service which the banks provide to their clients. This, however, does not seem to be a very realistic approach to the problem. We have to prove the feasibility and viability of the interest-free banking system as a business institution rather than a relief organisation. Any assistance by a bank to any party involves incurring certain costs for which a bank, being a business institution, has to be compensated. The solution for this problem has to be found on business lines rather than as a goodwill gesture from a partner. Moreover, there is no denying the fact that the party which borrows for a short-term period is going to put the borrowed funds to some use from which certain earnings can be, and usually are, derived. The bank has a right to share in the same with the borrowing parties or the clients. Perhaps a realistic approach would be that the bank classifies these short-term loans into various categories. Let us have a look at the various categories of short-term loans and their respective treatment in interest-free banking.

(1) *Short-term loans for one year or a quarter thereof.* This category would include loans for a period of three months, or a quarter of a year, up to one year. This period is adequate for determining the actual profitability of the funds used by the borrowing unit. Many firms draw up quarterly accounts for internal purposes of budget control and managerial efficiency. If this is done, or can be done by the borrowing firms the problem can be solved for the banks. Alternatively, the average annual rate of profitability for the borrowing firm can be used as a criterion for a quarterly period and can be applied for two to three quarters as the case may be. The annual rate of profitability of a particular borrowing party is known to a bank and can be determined very easily and, therefore, can be used in case it is not possible to determine specifically the actual return earned on the borrowed funds in as much as they become a part of total funds used by the borrowing party.

(2) *Short-term loans for one month to three months.* For this period there are again two possibilities:

(a) Either we can apply the annual rate of return criterion to the small fraction of a one year period, i.e. one month to three months; or
(b) We can try to determine the specific rate of return on the borrowed funds. In case these short-term loans for one to six months maturity are obtained for the classical type of "self-liquidating" bills, namely financing the import or purchase of any particular goods such as spare parts, industrial raw material, and such other purposes, the specific profitability resulting from the additional funds can be determined without any difficulty.

(3) *Short-term loans for less than one month.* Loans for a period of less than one month are usually meant for improving the liquidity position of the borrowing firm. In the cash management of the borrowing firm or persons, there may be some unavoidable difficulties of synchronisation of inflow and outflow of the cash resources, thus necessitating additional liquidity. With the passage of time the cash management of the borrowing parties or funds can be improved so as to minimise the need for borrowing funds for this purpose. To the extent, however, that this becomes unavoidable for the borrowing firm, it can make use of the credit facilities from its bank. Since the nature of the problem is to supplement or improve the liquidity position rather than investment in the real sense, the criterion of

rate of return is neither relevant nor feasible. The bank can guard as well as remunerate itself by doing two things:

(a) There will have to be a "limit" on the amount or the standing "line of credit" or overdraft for the short-term liquidity requirements, based on the average deposit balance or credit of the borrowing party for the entire year.
(b) The bank can compensate itself for the cost incurred on the transaction, that is first debiting the account of the borrowing party and later crediting the account. For this purpose the bank can recover a "service charge" based on scientific lines. This service charge, on a per transaction basis, will be different from interest because it will not be tied down to the length of time within one month or to the amount borrowed. Moreover, realising service charges is not new for the banking business.

(b) Consumer Credit

Another unresolved issue in the context of interest-free banking is that of consumer credit or non-productive credit, which has always been an unavoidable phenomenon in any kind of society. Mostly this phenomenon has been pertinent to the poor and the needy in the low income brackets. The purpose has been mostly to meet certain unanticipated exigencies for personal or family purposes. Today, however, the phenomenon of consumer credit has gained a new dimension. Present-day consumer credit is characterised by two phenomena. First, it is not confined to the poor and the needy in the lower income groups but has become a practice or phenomenon for the middle class. Secondly, the purpose of consumer credit in the new context is not meant only to meet certain exigencies, but is a conscious and deliberate attempt to raise the standard of living, wherein consumer credit is required to finance the purchase of durable consumer goods, house building, etc. Higher demand for consumer credit today is the result of a conscious and planned effort on the part of the producers and sellers of durable consumer goods. In other words the created demand for the newly developed durable consumer items has tempted the people of the middle class to raise their standard of living in advance of higher income expected in the future, or sometimes even without this expectation. In the latter cases the repayment is made out of the salaries of the people over a period of time. A question, therefore, arises as to what will be the solution of the problem of consumer credit in an interest-free banking system.

The question of consumer credit can be examined on the basis of the different segments of population from which the demand for such credit emanates. Let us first take the case of consumer credit for the low income groups. The segment of population in this category might consist of two sub-sections, one consisting of the people employed in government agencies or in the private sector, and the second consisting of the self-employed people and farmers in the agricultural or rural sectors. As for the employed people they can meet their requirements of consumer credit from their respective employers. In cases where schemes of a contributory provident fund or pension fund exists, this can be done even more conveniently. As far as the self-employed people and the rural people in the agriculture sector are concerned this may be done through co-operative banks or such other specialised agencies created by the government.

Coming to the consumer credit of today used by people in the middle class, a fundamental question arises at the outset. The question is whether it is desirable to encourage people to live beyond their means in a race for raising their standard of living. From the socio-economic point of view, perhaps this may seem quite undesirable in any society including the high consumption societies of the West. Many sociologists and economists in those countries are worried about this phenomenon in the rich countries. While the sociologists are concerned about the desirability of "living within one's means", the economists are concerned about the excessive credit expansion and susceptibility of the economy to the cyclical fluctuations. The case in developing countries or relatively poorer countries is slightly different and may seem desirable and unavoidable from a socio-economic point of view. Here again the people concerned may be either employed or self-employed. The employed people can again use the facility of borrowing from their employers to finance the purchase of durable consumer goods. As for the credit meant for house building purposes, this can also be partly met from the employers as is the practice in government agencies and the private sector in most of the countries. However, there can be also a specialised institution sponsored by the government to provide housing facilities on a hire purchase basis. Alternatively there can be private agencies which make available houses on a hire purchase basis. The self-employed people can use the facilities of the specialised housing agencies in the government or in the private sector.

In spite of alternative available sources there may be a residual demand for consumer credit which has to be met by the commercial banking system. This residual demand can be met by the commercial banks partly by financing the commercial houses or agencies which supply the goods on hire purchase or on an instalment basis. In other words, instead of meeting the demand side, the commercial banks would mostly finance the supply side and share the profit with the agencies selling the durable consumer goods on hire purchase or on an instalment basis. Thus, by a process of elimination there will be a very small section of the population which may approach the commercial banks for consumer credit because no other alternative sources are available. A commercial bank in an interest-free banking system will meet this residual demand on the merit of the cases, out of the residual fund available to them. The residual funds with the banks may be in the Current Account deposits or Savings Bank deposits. The banks can charge a small amount as service charges from the borrowers in order to cover the administrative expenses involved in the activity.

VI. Summary and Conclusions

The theory of interest is the weakest and the haziest part in the economic theory. No proper explanation and no satisfactory interpretation is available to explain the rationale of the present-day interest on capital funds. The justification of payment for capital is usually based on accumulation of physical "capital goods" in a primitive society, which cannot be justifiably applied to the present day "capital funds" or "cash capital". Moreover, the existence of interest in its present form as a reward for capital has created problems in the economic operations in the industrialised societies of today. According to many theorists, the recurrence of trade cycles and fluctuations in economic activities is explained by the phenomenon of interest and the operation of banking in its present form.

From a conceptual point of view it is difficult to establish a justification for separate existence of capital as a factor of production. It seems desirable and pertinent that capital should be treated as a tool or instrument of enterprise, the dichotomy between enterprise and capital is resolved, and they jointly become one factor of production. This will mean that profit will be a reward for enterprise including capital. This will be a neat and harmonious arrangement because the bulk of the capital in the present-day economies of the world is made available in the form of risk capital or equity capital from the entrepreneur in one form or the other.

After merging capital as a part of enterprise and establishing profit as the only form of reward for the joint factors of production, the basis of banking has also to be revised. Banks being the mobilisers of the savings or capital funds can serve as an intermediary link between the savers or the suppliers of the capital and the actual users of the funds or the entrepreneurs. In the framework of interest-free banking, there will be a triangular relationship of the three.

In the Islamic framework, interest-free banking can be run on the basis of *Muḍārabah* or profit-sharing arrangement, between the suppliers of the capital and the users of the capital. There will be a two-tier arrangement of profit sharing between the entrepreneurs or the ultimate users of the investible fund and the banks and at the same time there will be a profit-sharing arrangement between the banks and the depositors who are the savers or suppliers of the funds. The percentage or ratio of the profit sharing can be two-thirds for the users and one-third for the suppliers of the funds. The banks will thus get a share of one-third from the profit earned by the actual investors. Similarly, the depositors will get one-third from the share received by the banks. This will apply to the main profit-earning activities of the bank. The arrangement may seem to be complex at first sight, but will become mechanical and routine after a while.

As for the very short-term loans required by the clients of the banks, they can be made available out of the idle funds available in the Current Account category of the commercial bank in an interest-free banking system. No interest will be charged on very short-term loans for periods not exceeding one month. However, the banks can recover a service charge from the borrowers to cover the cost of operations and the appropriate portion of overhead expenses. For the periods between one month and one year, there are two possibilities. Either the actual profitability of the funds used by the actual investors can be worked out to serve as the basis of profit sharing; or alternatively an average annual rate applicable to the overall business of the entrepreneur can be applied. This will resolve a very pertinent question which is asked about the feasibility of the interest-free banking system.

As for the question of consumer credit, already there are doubts expressed by sociologists and economists in the developed countries as to whether it should be encouraged or should the people be asked to live within their means. To a large extent, the genuine demand for consumer credit can be met by other sources of borrowing such as specialised agencies sponsored by the government or by borrowing from their employers, in the case of employed people. There will be thus, by a process of elimination, only a residual demand for the consumer credit which may have to be met by the commercial banks. Interest-free loans can be made available by the commercial banks for this purpose out of the Savings Bank Account deposits, wherein the motive of the saver or depositor is not to earn profit. However, banks operating an interest-free banking system will be entitled to recover from their clients a service charge to cover the operational expenses involved in making the loans and recover the relevant portion of general overheads allocated to that department of the banks.

In this way, a conceptual and workable framework can be developed for interest-free banking, which will not only be according to Islamic tenets, but will also eliminate a conceptual defect in the present-day economic theory.

Postscript

In response to discussion that followed the presentation of this paper at the Conference, the author adds the following notes:

(1) Only the principles and guidelines of an operation framework of interest-free banking have been discussed in the paper. The basis of allocation and distribution which seems different or difficult in discussion will become a simple matter of routine operation when

implementation is started. After all, insurance companies deal in large numbers too. They determine and distribute their "bonus" or share of profits to a very large number of policy-holders who opt for "policies with profit". With the facilities of computerisation, now available to practically all the banks, there is hardly any problem in distribution of profits in place of interest. Moreover, commercial banks in the present-day system of supposedly simple operations, on the basis of interest, have also to go into complex computations. This is especially involved in calculation of interest for exact amount of balance and "number of days" on saving bank deposits, as well as "overdraft" or "running credit".

(2) The outline of banking operations in a system free of interest has been presented naturally in a skeleton form rather than in the form of a detailed scheme in view of the scope and limitation of the paper. Some readers may possibly point out that the operational framework of banking operations in the above discussion has a greater orientation towards "investment banking" rather than "commercial banking". This, however, would not be very correct. Investment in shares or securities has been suggested only as one of the uses of funds or only a partial operation of banking in an interest-free system. Even in the present day system of banking, "investments" constitute usually 25 to 30 per cent of the total "earning assets" of a typical "commercial bank". Moreover, the elimination of interest from banking – in an Islamic framework – inevitably involves the principle of "profit-sharing" or "equity-participation". There may be some apparent resemblance with "investment banking". This is not by accident but by design in view of the conceptual framework of banking in an interest-free system. Every society and economic system is bound to have its own model and guidelines for detailed operations. To an outsider the form and operations of an institution in a new system may seem different from its counterpart in the present system; but this is the way it has to be. By the way of analogy it may be mentioned that combination of "economic motives" or the so-called "rational economic behaviour" with Islamic injunctions and value system is unavoidable in an Islamic system distinguished from the present day pattern in other systems. So is the case with other institutions such as system of government, philosophy of criminal laws, orientation of punishment, etc. Thus, any resemblance between "commercial banking" in an Islamic system with "investment banking" in the present-day Western system is understandable. In fact, it is because of the institution of "interest" that a dichotomy between commercial banks and investment banks has developed in the modern capitalistic societies, exactly as "capital" has developed as a factor of

production, independent of and distinct from the factor "enterprise". Since the institution of interest is to be eliminated in an Islamic society, the detailed shape of "commercial banks" will be naturally different from that of the existing commercial banks.

(3) In the 1970s, the problem of inflation has assumed a significant magnitude and constitutes an important economic problem. It is, therefore, quite natural that people may wonder about the position of interest-free banking in the context of inflation. Substitution of the principle of "profit-sharing" for a fixed and predetermined "interest" eliminates the problem of a very limited return to depositors in the existing banking system. The rate of interest is predetermined and is not revised quite as frequently as the general price level keeps rising in inflationary situations. Thus, the savers face a little problem in spite of upward revision in the rate of interest from time to time. In a system of interest-free banking this disadvantage to the depositors will be easily eliminated, and there should be no problem in mobilisation of savings. The share of the deposits will rise in the same proportion as the profits to the users of the funds or investors. In fact in the present day situation of rapid inflation, commercial banks are making unjustified "inflation profits" because the rate of interest they charge from the parties are revised and varied not only from case to case but from time to time, whereas the rate of interest paid to the depositors remains relatively stable, the bank thus enjoying the profit between these two rates. Moreover, in an inflationary situation businessmen generally gain from inflation to the extent that prices of their products or commodities rise very rapidly, thus widening the "margin of profit" in spite of higher rates of interest charged by the commercial banks. In an interest-free economy there is a permanent tie-up among the three parties, namely the depositors, the bankers and the clients obtaining funds from the banks, thus eliminating the possibility of undue advantage or disadvantage to anyone among these.

Notes

1 Keirstead, B. S., *Capital, Investment and Profits* (New York: Wiley, 1959), p. 50.
2 Keirstead, *loc. cit.* p. 52.
3 Hayek, F. A. von, *Monetary Theory and Trade Cycle*, pp. 189–190.
4 See Holy Qur'ān, *Sūrah al-Baqarāh*.
5 Imam Raḍī-al-Dīn Muhammad Muhammad al Sarakhsī *Al-Mabsūt* (Cairo: Matba' Sa'adah) Vol. XII, p. 17.
6 Abū al-Walīd Muḥammad Ahmad b. Rushd Al-Qurtubī, *Bidayātu'l Mujtahid wa Nihāyatu' l-Muqtasid* (Cairo: 1329), p. 205.