

Economics

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Islamic banking has developed from its early experiments of the 1960s into a major force in the Islamic world, with assets of more than 100 billion dollars, and is still growing rapidly. Today it is not difficult to find an Islamic bank or an Islamic branch of a conventional bank in many Islamic countries. Responding to the needs of their Muslim clientele, some major Western international banks have set up their own Islamic branches as well. Even in Australia, the relatively small Muslim community has managed to set up its own financial institution. This is equally true for a number of other Western countries such as the USA.

The role of Islamic banks in the life of Muslim communities is increasingly active as more and more institutions are being established – from village banks to major international development banks. All this in competition with conventional banks but with significant cooperation with them as well. Such growth and development has not, however, had a smooth ride; the catchphrase has been 'proceed with caution'. Nevertheless, Islamic banking has moved on from its rather naïve, simplistic and moralistic models of the 1950s and 1960s, models which were solely based on Profit and Loss Sharing under the extremely risky contracts of *musharaka* (partnership) and *mudaraba* (commenda).

#### Approaches to Islamic banking

Three approaches to Islamic banking may be identified and placed on a continuum: idealist, pragmatic and *maslaha*<sup>1</sup> oriented. The idealist approach seeks to retain the 'purity' of Islamic banking by restricting it to contracts allowed under Islamic law. This was the 1950s and 1960s model. At the opposite end of the continuum are the Muslim scholars who argue that interest is not inherently evil and that the term *riba* does not include modern bank interest. This approach is the most 'liberal'; indeed, it even makes a case for there being no need for separate Islamic banks at all. Provided they adopt ethical principles, conventional banks, in their view, can provide financial services. Between these two extremes lies the pragmatic approach, which is realistic enough to see that the idealist model of Islamic banking has significant problems in terms of feasibility and practicality but, at the same time, does maintain the interpretation of *riba* as interest. The majority of Islamic bankers are pragmatists, who are prepared to balance practicalities with traditional Islamic principles.

#### Pragmatic adjustments

The result has been that these bankers and their *shari'ah* advisers have opted for a less risky form of Profit and Loss Sharing by modifying traditional contracts, such as *mudaraba* and *musharaka*, to suit the banking needs of the late 20<sup>th</sup> century. More importantly, for the bulk of their financing and investing operations, they have opted for safer and less risky contracts such as *murabaha*, which is very similar in some respects to lending on a basis of pre-determined return. So successful has this been, that *murabaha*-type contracts now make up at least 75% of such investment operations of most Islamic banks, despite the concerns of some idealists that *murabaha* could be used as a back door to dealing on an interest basis. This is a pragmatic triumph indeed. Simultaneously, the use of the less secure contracts such as *mudaraba* and *musharaka* has been dramatically curtailed, retaining only a small share of assets on the investment side.

The pragmatists have also adjusted the concept of money, which, in the *shari'ah*, is

equivalent to 'coin' and a mere medium of exchange. In the *shari'ah*, money cannot be sold for money, that is more for less, and it should not have a 'price'. This definition of money, espoused by the idealists, has been modified in the interests of practicality. This adjusted concept of money exists quite comfortably with notions of the value of money in relation to time, of present value being higher than future value, and of it being possible to charge a sum against time in certain types of debt.

A third pragmatic adjustment is the interpretation of *riba*. Without question the theoretical position of Islamic banking is that *riba* is equivalent to interest in all its forms: nominal or real, fixed or variable, simple or compound. Nonetheless, in Islamic banking practice, *riba* has come to be considered a 'legal' concept rather than an economic one; that is, it is seen as a contractual obligation on a borrower to pay an increase in a loan – money for money. Under this legal definition, certain contracts that allow for fixed interest are now feasible. A case in point is the *murabaha* contract. Prominent theorists of Islamic banking argue that there is no substantial difference between fixed interest and mark-up in a *murabaha* contract. The latter is considered acceptable in Islamic law, as it does not involve exchange of money for money. In strictly economic terms, however, the mark-up (profit) in *murabaha* would be equivalent to fixed interest. Similarly, the legal maxim has been relaxed, according to which 'every loan that begets an advantage is *riba*'. This is seen, for instance, in the case of inter-bank operations in which reciprocal placement of funds on an interest-free basis is made. Money is advanced by one Islamic bank for a certain period of time, on an interest-free basis, on the understanding that the other bank reciprocates at a later date, either with the same amount of funds, or with less over a shorter time.

As part of this more pragmatic orientation, the concept of paying a 'fine' is now widely accepted in Islamic banking. This occurs where a debtor defaults on a loan despite being able to repay. A fine, which can be equivalent to the normal rate of return, can be imposed on the debtor by the bank. The *shari'ah* boards generally approve of this fine as compensation for the loss suffered by the lender. Similarly, variable commissions or fees are charged on certain transactions, such as purchase of traveller's cheques, and this has also become generally acceptable in the practice of Islamic banks. Another interesting development is the offering of 'prizes' to savings or current account holders in order to encourage depositors to keep their deposits with the bank.

Examples of these pragmatic adjustments are also available in the case of profit and risk. In the former, Islamic bankers do take into consideration market interest rates in calculating their profits when making financing or investment decisions. A further change is that it is now accepted in practice

that time can enter into the calculation of profit, although in the literature many early jurists object to the idea of varying the amount of profit according to the time involved. As to risk, there has been somewhat of dilution of the idea that money must first be risked in order to earn a return. In Islamic banking today, there are many examples of risk-minimization: *murabaha* profit, short-term commercial *musharaka* and *mudaraba* profit, and rent-sharing arrangements.

The pragmatic approach has been successful in a number of other interesting developments in Islamic banking. Some Islamic banks have begun to use what may be termed 'cleansing' of profits earned from investing in companies which deal on a basis of interest. According to a complex formula, the *haram* share of the profit related to



these companies and in which the Islamic bank has invested, is taken out before profit from a particular portfolio is finalized. Similarly, a number of Islamic banks are experimenting with the idea of 'securitization of debt' and trading in such debt, again another innovative idea. A further issue under debate is whether profit can be predetermined. If ultimately accepted, this practice will change Islamic banking dramatically, bringing a large number of contacts, which are not yet acceptable to Islamic banking, into the fold of acceptable products.

In all of this, Islamic bankers have thus been highly creative in their approach to the development of their institutions' operations. Although Islamic banking has its roots in the idealist literature, it has undergone a process of redefining the acceptable, made possible by the flexibility available in interpreting *shari'ah* texts, as well as by the need to keep pace with the present global environment. What we are seeing is that the pragmatic approach has facilitated the development of a viable Islamic banking sector. However unacceptable these adjustments may be to the idealists, they have nevertheless provided Islamic banking practitioners with much needed flexibility in designing appropriate *halal* investment products for their Muslim clientele, and this is likely to continue in a more radical fashion into the future. ♦

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#### Notes

1. *Maslaha* is the underlying reason or the objective of a given ruling in Islamic law; public interest.