

ISLAMIC FINANCE

AN INTRODUCTION – PART TWO

IN THE FIRST ARTICLE IN THIS SERIES MARK ANDREWS, HEAD OF ISLAMIC BANKING AND FINANCE, RISK REWARD LTD, COVERED THE BASIC PRINCIPLES OF ISLAMIC BANKING AND DESCRIBED THE FUNDING SOURCES OF AN ISLAMIC BANK - OR WHERE IT GETS ITS MONEY FROM. IN THIS ARTICLE, HE WILL BEGIN TO CONSIDER THE OTHER SIDE OF THE BALANCE SHEET, THE ASSET SIDE - OR WHAT AN ISLAMIC BANK DOES WITH ITS MONEY. TO DO SO, HE CHALLENGES THE READER TO FIRST DEAL WITH THE ISSUE OF "RIBA" BECAUSE IT IS CRUCIAL TO BOTH UNDERSTANDING AND ACCEPTING THE BASIS ON WHICH A MODERN ISLAMIC BANK TRADES.

Understanding the Concept of Riba

In over simplistic terms "Riba" means "interest" and Islamic Banks may neither charge nor pay interest on their funds. Its prohibition is contentious in some quarters, especially amongst non- Islamic institutions, but the fact remains that there is unanimous support amongst all Islamic Scholars for a total ban.

This ban or prohibition is often reported in critical terms by outsiders, which is ironic given that most developed economies have banned interest to some degree or other during their histories. However a total and not just partial ban seems both draconian and anachronistic at first sight.

There is also an unhelpful "elephant in the room" which makes understanding more challenging. It is quite a big elephant actually and is normally described thus: "If it is correct that Islamic Scholars have banned the charging or paying of interest of any kind and for any reason, why is it that all Islamic bank accounts, deposits, savings plans, loans, bonds, leases, credit cards, in fact almost every Islamic product, are linked in practice to one kind of interest rate or another? This is surely either a fudge or it effectively undermines the ruling!"

The standard answer to this accusation is that "linking something to an interest rate is not the same as actually charging or receiving interest". This is obviously true in academic terms but it doesn't convert many doubters. More convincing and comprehensive explanations are required to do that and we will consider a few of these key arguments next.

First and foremost, "Riba" as originally described, is not the same as modern day interest and it is a bit confusing to connect the two directly even though the latter is now banned under Islam as if they were. Secondly, there is no direct or accurate translation from ancient Arabic into English of the word "Riba", which adds to the uncertainty. The closest modern approximation is "Usury" or "an unwarranted, unreasonable or unearned premium, excess or surplus which is neither deserved nor fair".

As mentioned earlier, the prohibition of interest, especially usury, is not confined to Islam and has a long history spanning several traditions and civilisations including our own. Whilst everyone would accept that forbidding Usury is both correct and morally right, it is less clear to outsiders why Islamic

Scholars have decided to ban interest completely given the crucial role it plays in Western economies. The simple answer is that an Islamic economy was and still is different.

Quranic References

The Quran (Book of Allah SWT) refers to the term Riba several times but no definition is available and no detailed explanation is given in the practices of the Prophet (PBUH). Islamic Scholars don't know why, but they believe there are two likely reasons for this. Firstly, verses containing Riba were revealed towards the end of the Prophet's (PBUH) life and there may simply not have been enough time for the issue to be raised and explained. Secondly and perhaps more likely, the concept was so well known (like Usury is for us today), that no explanation was needed so everyone knew and agreed that Riba was wrong.

At the time of the Prophet's (PBUH) life, money was not regarded as a store of value and was not created to be hoarded for its own sake. This gives rise to one of the more powerful Islamic arguments against interest which explains more clearly the logic of the total ban.

If several people enter into a business venture together, then under Islamic rules, they must agree to share both profits and losses at the outset. Suppose each partner brings a different skill or input to the venture such as cash, labour, know how, or assets? It follows that each will request a share of the projected profits (and loss) based on the scarcity or demand for their particular contribution. In this way, everyone's return is agreed at the outset and is linked directly to the outcome of the venture.

If the venture fails, all will lose. If it succeeds, all will gain. No party can receive a minimum or guaranteed share even if the venture fails, yet this is precisely what would happen if the partner with the cash charged interest, or the partner with the know how wanted his pre-calculated profit share, regardless. In both cases the return demanded is deemed by Islamic Scholars to be unfair, excessive, unearned and unreasonable because it is not trade related and not actually earned.

The Quran explicitly prohibits Riba so anything that can be defined as Riba must be outlawed. The problem is, does this mean all interest or only some? There have many scholastic debates, including attempts to legitimize bank interest, but on balance and after what is now centuries of deliberations, the unanimous current view is that all interest is Riba and is

ISLAMIC FINANCE: AN INTRODUCTION PART TWO CONTINUED



therefore is banned. In fairness it is hard to see, irrespective of the scholastic arguments, how partial prohibitions/exclusions could work equitably in practice.

The prohibition on charging interest does not preclude using interest rates as a reference point for calculating profit returns, as long as these returns are not linked solely or directly to interest rates themselves, as this would create uncertainty or Gharar as well as Riba, both of which are forbidden.

So there is no Islamic objection to a bank using interest rates as a reference point to calculate the required profit return as long as the amount is certain, the return is fixed, the project is trade related and the bank has a genuine stake in the outcome.

This takes us neatly back to the standard answer that “charging interest and using interest rates as a reference point is not the same”. It is indeed “not the same” and until a more reliable and independent mechanism for measuring returns and opportunity costs emerges, interest rates look set to retain their benchmark status.

So, if an Islamic bank cannot charge interest per se, but can use interest as a reference point on an opportunity cost basis, how does it structure its products to make a return? The answer is to provide a range of services that are genuinely profit (and loss) sharing and in which the bank’s required profit return or share is calculated using benchmark interest rates, is agreed with the client at the outset but actually depends on profit generation for payment.

There is a further complication in that to be Shariah compliant all lending activities have to be trade based, must involve real goods and services, must involve actual trade, avoid any uncertainty, avoid prohibited practices and must be carried out with the utmost integrity and good faith.

Applying these rules to an Islamic bank’s “lending” services has produced some complex sounding products but once these have been explored and understood it is relatively easy to identify a conventional bank equivalent.

We will cover only one in this article and that is the Musharaka, sometimes know as Shirka which translates to “sharing” and is the Islamic form of partnership.

Musharaka

Under a Musharaka one or more parties contribute to the financing and management of a Sharia compliant project agreeing to share profits and losses at the outset.

In the absence of an agreement profits and losses are shared in accordance with each partner’s capital contribution. Losses are always attributed in accordance with capital contributions so the biggest stakeholders stand to lose/gain the most, which is fair.

In a Musharaka arrangement, the Islamic Bank contributes funds to the partnership in return for an agreed profit share, usually calculated by reference to short or medium term interest rates depending on the length of the partnership. The bank can be either a permanent or diminishing partner and can take security either directly or from third parties.

A Musharaka project is akin to equity finance and is almost as close to ethical and pure trade related banking as it is possible to get. The genuine sharing of profits means the bank has a real stake in the outcome of its “clients” business and forces it to concern itself very closely with the management and completion of the scheme. The fact that the scheme must be Shariah compliant means it is genuinely wealth and trade enhancing and is concerned with beneficial activities only.

All well and good so far, except that very few banks are active in this market at present. Why?

The main problem is that as with equity finance, the due diligence process for a Musharaka is considerable as is the ongoing management and monitoring obligation. The costs of this direct involvement by the bank cannot usually be rewarded adequately by the profit sharing arrangement neither can the very real risk of incurring losses be built in sufficiently. The net result is that whilst the Musharaka remains the shining example of Islamic ethics and principles, the hard truth is that it is not used that much in practice because it cannot be made to pay commercially in a modern banking environment. Other Islamic products require much less supervision, earn just as much for the bank and are therefore the preferred offerings.

In Islamic Finance: An Introduction – Part 3 (Global Risk Update Q4 2009) we will cover these preferred “lending” products and will show how Riba influences their structure. We will also explain why the two main offerings, Murabaha (means “sale”) and Ijara (means roughly “lease”) are the two key offerings.