

Bank Interest And Islamic Banking System

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Abstract: The outthought in an orthodox and contemporary Islamic perspective reoffering to the ugly element of usury self-centeredness' and greediness syndrome, screening our happiness with the aims of missing profit and income, to day Muslims Business men and women previewed a lot of disasters in form of fire incidence arm robbery, flooding etc. This paper seeks to expose these danger and forward scriptural solution and explain breeding ground of usury. And also recommends the utilization of elements such as prophet Muhammad (S.A.W) approaches and interpretations of Muslims jurists to control the geographical scope of usury (Riba) in Islam This paper examines the concept of usury or Riba as was understood at the time of the Prophet of Islam and his contemporaries in Makka and Madinah, and the different interpretations of the term developed in succeeding centuries in Muslim populated countries of the world. In Islam, It demonstrates that Riba and interest are not synonymous terms, and that what Islam forbids is usury and not interest. It asserts that, although some interests are usurious, the claim by the contemporary Islamic Banking and Financial institutions that these institutions while are Islamic ones has because the term interest is not used in their transactions, and is misleading at best. It ends with the proclamations that true are not only feasible, but also are inevitable to serve the needs of the Muslims around the world.

I. INTRODUCTION

Islamic Banking and Financial Institutions have been in operation in countries for around four decades, yet in most Muslim countries where Islam as well as conventional banks operate, they are relatively very small, and command even smaller market share. It is not that the majority of the Muslim citizens are ambivalent about Islam, but they do not either believe in the Islam of that these institutions do serve their needs. There are good reasons for skepticism on both counts. The basic impetus for the creation of the Islamic Banking and Financial Institutions came from the belief of their modern proponents that all interest, irrespective of type and magnitude, are usurious (Riba in Islamic lexicon). In order to avoid the term "interest rate" the Islamic Banking and finance resurrected some financial practices that existed at the time of the Prophet Mohammad and the early centuries of Islam. The Islamic jurists continue to approve practices that were evolved from the earlier institutions and instruments without a critical

examination to determine whether or not they meet the Islamic precepts of justice and fair play some say efficiency and serve the needs of the public in a Muslim country. The objective of this study is to show the real historical meaning of the term usury or Riba in Islam, and why Riba should be interpreted as usury and not ordinary interest rates. It examines how Riba has come to be identified with interest at modern times, and how some Muslim scholars has incorporated this limited or narrower interpretation in forming the Islamic Banking and finance

The study briefly describes the operation of the contemporary Islamic banking and financial institutions and shows how these can be changed and restructured to operate on truly Islamic principles.

II. TYPOLOGY OF RIBA AND ITS IMPLICATIONS FROM THE ISLAMIC PERSPECTIVE

There are consequences of practicing and utilizing usury (Riba) in our daily lives. Parts of the dangerous implications were discussed in the following verses as follows:

“O you who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to God, that ye may be successful.” (Chapter III, Verse 130)

“O you who believe! Observe your duty to God, and give up what remain (due to you) from usury, if you are (in truth) believers. And if you do not, then be warned of war (against you) from God and His messenger. And if you repent, then you have your principal. Wrong not, and you shall not be wronged.”(Chapter II, Verses 278-279).

“Those who swallow usury cannot rise up save as he arise whom the devil has prostrated by (his) touch. That is because they say: Trade is just like usury; whereas God permits trading and forbids usury. He unto whom an admonition from his Lord comes, and (he) refrains (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with God. As for him who returns (to usury)—such are rightful owners of the Fire. They will abide therein.”

(Chapter II, Verse 275).

“God has blighted usury and made almsgiving fruitful. God loves not the impious and guilty.”(Chapter II, Verse 276).

The Arabic word for usury is Riba (pronounced as Rēē ba). According to the noble Quran (Chapter 3, Verse 130, quoted above), Riba is defined as doubling and quadrupling (the sum lent). This is the only definition of Riba available from the Quran. Admonish the believers to refrain from usury and avoid God’s punishment. According to Ibn Kathir argued that the Qur’anic verse 3:130 on Riba essentially talks about Riba-al-Jahiliya (i.e., usury practiced in the pre-Islamic period in Arabia). According to Al-Tabari in his Jami points out that Riba in the pre-Islamic period referred to doubling and redoubling of the principal amount lent in commodities over a period of time. If the borrower failed to repay the amount borrowed, the loan was extended for another year but the borrower had to pay double the quantity originally lent. If, at the end of the second year, the borrower again failed to repay the loan, the loan was extended again for double the quantity of the second year to be repaid next year. Thus, in two years’ time, the insolvent borrower would owe the original lender four times the quantity lent to him. Al-Zamakhshari, in his al-Kashshaf (p. 234, n,d), presents a similar interpretation pointing out that even a small debt could consume all the wealth of a debtor because of repeated doubling of the unpaid loan. also gives a similar interpretation of Riba, that is Riba al-Jahaliya. Prophet Muhammad in his farewell Hajj clearly proclaimed that Riba al-Jahiliya is null and void from this day and that Riba of Abbas bin Abdul-Muttalib has been waived. Riba was well known among the Arabs. A person would sell something on a deferred payment basis and upon maturity the creditor would ask: Will you pay (now) or add an amount to the bill? Those who equate Riba with interest seek support from who claimed that pre-Islamic Arabia practiced a form of Riba where money was lent at a predetermined sum over the principal amount (Ahkam al- Quran, V. 1: 465). However,

there is no historical evidence to suggest that Riba al-Jahiliya also consisted of transactions that were similar to modern loans on interest. Thus, the basis for equating all forms of interest, whether they double or quadruple the principal or whether they are a small fraction of the principle, must be sought elsewhere.

III. TYPOLOGY OF USURY (RIBA) AND APPROACHES OF MUSLIM JURIST

The traditions of Prophet Muhammad on Riba are essentially confined to Riba al-Fadal dealing with the borrowing of commodities e.g., gold, silver, etc. but exchanged at the same point in time. i.e., exchange gold for gold or for silver, unless it is part of a barter transaction, which is perfectly legitimate form of trade under Islam. Cites a considerable hadith dealing with Riba. A very few Hadith indeed, if any specific one can be found in the verified collection of Hadith on Riba al-Nasia, i.e., collection of fixed and predetermined percentages of return on the amount of money lent, popularly known as “interest.

“Then one wonders what is the basis for regarding all kinds of interest as usurious? Is it the meaning of the Arabic word Riba itself which lends to this type of assertion? The word Riba apparently means “an excess or addition—i.e., an addition over and above the principal sum that is lent”

If the Muslim jurist are referring to interest as usury on the basis of this literal meaning of Riba, then naturally one wonders why God Almighty used the terms “doubling” and “quadrupling” (the sum lent) as usury in Chapter 3 Verse 130 (quoted above), and why there was no further clarification of this verse or by the Prophet. Some of the Muslim writers who claim interest is Riba, have no problems in explaining the verses of the Quran and the Hadith, as they simply translate the term Riba as interest and then assert it is forbidden. It appears as though they start with an axiom that interest is Riba and, as such, forbidden. There is no other basis. Riba in the context of loan (debt), the Hadith literature cites it in the context of sales, and there is no mention of loan (qard) or debt (dayan). One such Hadith that is often quoted, and is known by the epithet six commodities Hadith relates to the time around the Khyber Expedition well before the prohibition on Riba was imposed by Gods revelation was as follows

(it was narrated by Abu Sa’id al-Khudri on the authority of the prophet):“Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, salt by salt, like by like, payment being made hand to hand. He who made an addition to it, or asked of an addition, in fact dealt in usury. The receiver and the giver are equally guilty.” (nd V. III: 834).

This particular injunction said to have made by the Prophet to stop the cheating of the Muslims by the defeated hypocrites of Madinah who were trying to get back the valuables they had to surrender as part of the Khaibar Treaty. Mu,awiyah a very learned man of his time, questioned the validity of this hadith and also calling such transactions Riba. It is important to note here that when one borrows one commodity to be returned later, it is no longer hand to hand there is an elapsed time and, as such, it comes under the purview of Riba al-nasia i.e., deferred payment. If the paper

were to accept the six commodities hadith then all transactions that did not involve the use of money (i.e., barter trade) would be usurious. This is unacceptable from the view point of rational thinking as well as religious and moral principles. The Muslim jurists, depending on how transactions are considered, consider nasia transactions as installment payments at a higher price than the original (salam sale) or pre-determined mark up on the original price to illa be paid over time (murabaha transaction), and, therefore, permitted. Others contend that all nasia transactions to be usurious. Ironically, not only consider these transactions to be permissible, but make most of their profit from such practice! About 70 percent of assets in Islamic Banking and finance are Murabaha assets, while in the case of conventional banks, two-thirds of assets are murabaha (loan) contracts. Two concepts, (efficient cause) and hikma (rationale) need to be considered. The Fuqaha use illa to describe a transaction to be dealing with Riba. For example, the Quranic verse *lakum ru'usu amwalikum* i.e., "you shall be entitled to the return of your principal (2: 279)" is used for illa, ignoring the remainder of the verse, *la tazlimuna wa-la tuzlamun* i.e., "you will do no wrong, and neither will you be wronged, which provides the hikma. If the first part of the verse was taken literally, then the Islamic Banking and finance policy of profit/loss sharing cannot be accepted. The following excerpt from Afzal (1996) is quite instructive: "In many cases the 'Illa' approach appears superficial and devoid of moral considerations. For example, coins like 'fals' did not involve Riba in Maliki, and Shafi'i schools. Thus 100 'fals' (which were used as a unit of currency but were not made of gold or silver) could be exchanged for 200 either on the spot or on a deferred delivery basis. (Why today's fiat money could also be not counted in this category, Commodities which were countable like apples and eggs did not involve Riba, and hence could be exchanged less for more according to Hanafis. A piece of cloth could be exchanged for two pieces of the same quality and measure since it was neither measurable, or weighable, or gold or silver, or foodstuff and do not provide us with clear guidance as to whether or not interest is Riba (i.e., usury). Some of the Fuqaha or Muslim jurists are of the opinion that interest is Riba and, as such, it is prohibited. This view can be acceptable if it is solely based on the argument that the word Riba has only one meaning, and that is an addition over and above the principal sum lent.

In addition, all other arguments against interest (i.e., rates of interest which are only fractions of the principal sum) such as provided by Muslim writers or scholars are, at best, superfluous and self-serving. If Riba means any addition over money lent out, then no one can loan out money to someone else or an organization to share in profits or losses. In other words, one cannot be an inactive participant in business or trade ventures and share profit because he/she cannot get back money which is in. Just because one is ready to accept losses, does not entitle one to claim a part of the profit because he/she is a partner in capital. If Riba really meant "an addition to sum lent," then how did the traders during the life of the Prophet share their profits and losses with their aged and/or female partners who could not physically participate in the long journeys that such trades required.

Mudaraba or joint ownership does not necessarily mean that every single shareholder actively participates in the

decision making process as well as the implementation of the decisions. If Islam permits Mudaraba then it is difficult to understand how Riba can mean, an addition to the sum lent. Once Riba is defined as an addition to the sum lent, all arguments for joint enterprises, cooperative ventures (as not all members of the coops can participate in the decision making process or in implementation of those decisions), interest-free banking, and/or Islamic monetary policies become redundant and all these institutions become forbidden for the Muslims. The interest-free banks that operate in some of the Muslim countries are really indirect participants in Riba, in its literal sense. The practice of payments of commissions to the depositors or charging of variable or fixed fees from the borrowers, or lending less than the contracted amount while recovering the full amount, cannot be anything less than Riba. On the one hand, the Islamic Banking and finance claim interest is Riba and, as such, forbidden, while on the other, they are dealing in interest, but calling it profit/loss sharing. The fuqaha, it seems, have developed quite narrow interpretations of the term Riba to suit their own line of thinking. Some just substitute "interest" for the term Riba. Among them are Siddiqui, Naqvi, Faridi and Anwar, who argue that Islamic Banking and finance cannot deal with interests. Whereas, Sanhuri, al-Saud, Tantawi, Suhail and Yousuf Ali (in his commentaries on Quran 2:275 and 2:324); Shah, Rahman and Afzal make a clear distinction between Riba and interest.

IV. ISLAMIC BANKING AND FINANCE AND THEIR MODUS OPERANDI

The financial instruments used by the Islamic banking are numerous. According to Raphaeli (2006), the most frequently used ones are: "wadi'ah (safekeeping), mudharabah (profit sharing), murabahah (cost plus), ijarah (leasing), qardh al-hassan (benevolent loan), and musharakah (joint venture)". Wadi'ah is a non-interest bearing demand deposit (checking account) similar to the ones offered by commercial banks around the globe (although since 1980s, a small interest is paid on this account). It is also a non-interest bearing savings deposit account, but with a promise of giving hiba (gift) whenever the bank has profits to share. In practice though, Islamic banking claim to offer hiba which are a tad higher than the interests on savings account in conventional banks, to attract deposits. Ordinary depositors get nothing and accept that as will of God. Mudharabah (profit sharing) account is a form of time deposit that cannot be withdrawn before the contractual time is elapsed. The bank as the intermediary (mudharib) takes no risk when it lends money to the borrowers. The borrowers sign contracts that specify the principal amount borrowed and how much would be paid back, all predetermined. Since usually the cost of the loan is collected when the loan is given, i.e., the amount of the loan minus the cost is advanced, usually such loans are more expensive to the borrower than the ordinary commercial loans offered by conventional banks. If the borrower defaults on the loan, the loss is borne by the depositors to the bank. If the loan is repaid early, the borrower does not receive any part of the cost that the bank collected at the origination of the loan!

Murabaha (cost plus) transactions, a very profitable business for Islamic banking and finance is no different in character than that of a finance company. The Islamic bank buys the merchandise, adds an amount for profit and sells it to the buyer, to be paid back in equal installments. Even if the borrower would attempt to pay back the loan ahead of time, the payments are not reduced. For all practical purposes, murabaha loans have implicit rate of fixed interest rates that are higher than on installment loans from a conventional financial institutions. Ijarah (leasing) or ijarah waqtina (lease and purchase), is another way of enriching the Islamic banking at the cost of the borrower. The lessee cannot refinance or change the contract in view of changes in the market conditions. Any break in the contract goes in favor of the Islamic bank. Thus, the lessee can lose the equity in the property after if for some reason s/he can no longer honor the contract! Qardh al-hassan (goodwill loan) is given in good faith—the borrower is obliged to pay back the amount lent only, without any obligation to pay anything extra. It is quite obvious that not many loans would be given by a financial institution that is open for business of making money. Musharakah (joint venture) in which an Islamic Banking and finance clients jointly finance a venture by issuing participation certificates that can be bought and sold in the market. This type of joint venture is commonly known as sukuk and the participation certificates are traded like bond. Apparently, the market for sukuk mushroomed to around \$41 billion (Raphaeli 2006) fueled by Middle Eastern oil money that is being invested in building booms and other infrastructure. It is not clear how returns on such instruments are determined but, the returns are predetermined nonetheless (Siddiqi 2006). If the past is any indication, it would be based on returns from similar instruments issued by non-Islamic entities and would simply be labeled as profit sharing. It would be interesting to watch what happens when an IBFI fails to meet its obligations on sukuk to the investing public. The IBFI, at this period of bounties from oil exporting countries, seem to be doing financially alright.

V. ASSESSING THE OPERATIONS OF THE ISLAMIC BANKS AND FINANCIAL INSTITUTIONS

The brief review of the financial instruments above lends to an obvious question, in what ways do the so-called Islamic Banks and financial institutions qualify to be called Islamic? Apart from the claims that the Islamic Banking and finance institutions follow, Islamic principles, there is no difference in their operations than the conventional financial institutions, except for the fact that the Islamic Banking and finance institutions principal thrust are towards maximizing their own coffers at the cost of depositors and the borrowers. It can be demonstrated that the Islamic Banking and finance institutions use religious slogans to misrepresent the common people that these are functioning to promote welfare of the believers. In reality, most of their loans cost lot more than what the conventional banks charge. While the conventional financial institutions are subject to regulations and are accountable for their actions, the Islamic Banking and finance institutions are probably more prone to corruption and mismanagement, all

they need is a review from their shari ah council (in cases where the NBFIs are outside the supervision of central banks), that the transactions do not involve dealing with interest rates. The Islamic Banking and finance institutions frequently place their customers' deposits into short term instruments of conventional banks abroad to earn interests so that they can present their own depositors shares of their interest earnings as profits and/or, advance hiba (gift) to them!

In reality the Islamic Banking and finance institutions are deposit-taking finance companies if outside the central bank purview. Here in lies their attractiveness to the major financial institutions of the developed West. It is not that the Citibank or HSBC suddenly developed fervor for Islamic banks and financial institutions. Where else they can find easy way of making money without any risk or responsibility to their clients, and without being subject to regulations. After all, the Islamic Banking and finance institutions have been using their facilities to earn short term income (read, interest) and delve into futures, options, and other speculative transactions! The Islamic Banking and finance institutions, as institutions, seem to attract a fraction of the business of financial transactions in countries where the conventional financial institutions are allowed to operate. The total assets of all Islamic Banking and finance institutions are miniscule (see the 2005-2006 Annual Report of the Islamic Development Bank) compared to the conventional financial institutions in the Muslim countries, and compared to some of the regional banks' assets in the US. It will not take long for the Muslims to figure out that the sukuk transactions are nothing more than institutional bonds, but with mismatched risk-return relationship. It appears that no matter how the transactions are structured by the Islamic Banking and finance institutions as long as these are made into contract documents, these are termed as Islamic (Siddiqi 2006).

VI. STREAMLINING THE ISLAMIC BANKING SYSTEM

The IBFI should be reorganized into three distinct operational units. One unit should deal strictly with commercial and consumer banking, and the second one with investment banking, and the third one with commercial financing. The sources and the uses of funds of these institutions should be clearly delineated to avoid misuse of funds and public trust.

COMMERCIAL BANKING: The sources of the fund are depositors' money and the equity financed by the bank shareholders, the share of the latter as directed by national and international standards for commercial banks. The depositors should earn flexible rates of return based on the overall costs of and returns for the bank during a quarter, or such time by which the bank can estimate its net returns. All deposits ordinary savings accounts, or time deposits - should earn flexible rates, subject only to some adjustments for risks. Similarly, Certificates of Deposits, naira, should also earn flexible returns, unlike in modern commercial banks. In the past some modern banks have run into heavy disintermediation during rapid changes in the interest rates, and in some cases, went bankrupt when long term fixed loans at low rates could no longer be financed through costly

deposits. The Islamic principles of justice and fair play require that no party should take advantage of the other. Only flexible rates of interest/return can assure that. Insurance is an integral part of an Islamic economic system. Depositor's money, up to a certain limit, must be insured by some national system of insurance in a manner similar to the Federal Deposit Insurance Company of the Naira, or elsewhere. The depositors need to have some assurance that their funds would not be completely lost in case the bank faces serious economic problems.

This is also compatible with Islamic injunction of safeguarding the principal. The uses of funds should be limited to commercial and consumer loans, e.g. accounts receivable financing, inventory financing, line of credit, installment loans for short and medium terms, and mortgage financing. All loans should also be on flexible cost basis, i.e., the rates charged for these loans must be adjusted periodically as suggested above, based on returns to banks as calculated say every three months. The Federal Deposit Insurance inflows from foreign commercial banks would increase with such a system since they will no longer be tied with fixed rate commitments. The business community and the consumers in the Muslim countries will prefer the new system to what exist in their communities now.

INVESTMENT BANKING: The principal source of funds for this institution should come from the shareholders' equity. This can be supplemented by borrowing through the money market. Such a bank should not be allowed to use depositors' money. Its earnings will be fee based for intermediation services, and flexible returns from its investments. The activities of the investment bank should also be clearly monitored to avoid questionable practices and transactions. The role the investment bankers played in the Enron disaster in the US needs to be averted.

COMMERCIAL FINANCING: At present the Islamic Banking and Finance Institution are essentially finance companies. Their practices are contrary to what they are supposedly trying to avoid. The Murabaha transactions are fixed interest-bearing instrument in reality. No matter how quickly one pays back the loan, one has to pay the full extent of the mark up making them usurious (two-fold three fold increases in repayments). This and the instrument of ijarah Muntahia Bittamleek should all be modified and standardized, removing the need for Shari,ah councils, and be based on flexible rates only.

While the recent trend in the world of banking and finance is mergers and consolidation of institutions and functions, the idea of proposing a break up of Islamic Banking and Finance Institution into three separate functional areas may appear to be farfetched. Yet, this possibly is a very sound way to learn the ropes of running a flexible rate based banking and financial system. From the practice of determining, more or less arbitrarily, the profit or markup rate, the new institutions will have to institute a system of accounting to monitor very closely costs of and returns from operations so that they can set competitive rates for their customers. This will be a very difficult task, but must be undertaken in order to ensure that all parties are treated equitably. It appears that the Islamic Banking and Finance Institution have hitherto faced very little supervision and scrutiny from the banking authorities of the countries where they operate. It was this lack

of centralized supervision that led to the massive failure of the first NBF in Egypt just few years after its founding in 1963. This needs to be remedied. Not only these should be brought under the supervision of the monetary authorities, especially the central banks, but also be subjected to regular examinations by the regulatory authorities, results of which should be made available to the public. The IBFI disclose very little information to the public, and this keeps the depositors, the borrowers, and the investors in the dark about their financial health. This calls for improved governance standards and compliance monitoring. The restructured Islamic Banking and Finance Institutions must fulfill their fiduciary responsibilities wholeheartedly. At present the Islamic Banking and Finance Institutions lacks uniform standards and policies within and across national boundaries. There are attempts to bring in common accounting and financial practices by the Bahrain-based accounting institute and Malaysia-based IFSB. These need to be aggressively instituted, subject to the overall banking and finance policies of individual states. There will not be any meaningful role for the ever-present Shari,ah councils in the reorganized IBFI, and these should be disbanded in due course of time with improved supervision structures. Banking and financial operations should be left on the shoulders of those who are well trained and well versed in the management of financial services and instruments.

VII. CONCLUSION

It is important to realize that banking and financial institutions are engaged in a trade (tijara) that deals with the management of money and financial securities and services, and they do not operate like money lenders or loan sharks. The depositors place their deposits either for a short or a longer period, seeking some returns to offset the loss of purchasing power if kept under the mattress or to augment their future income, while the borrowers borrow to meet the needs for funds for business and/or consumption that are vital to them and are willing to pay a reasonable fee for the service. It should be borne in mind that banking/ financial institutions are only intermediaries and should act accordingly, and that the bank officials must be held accountable for their actions and should be held responsible for willful negligence.

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