

Islamic Banks as Catalyst Of Economic Development

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Abstract: This paper discusses the current *murabaha* oriented practice of Islamic banks in the light of rules of Islamic law. Special attention is given to the issue of return rate to a depositor. That rate may be variable or fixed depending on contract. In both cases, analysis will focus on increasing return rate as a technique to mobilize deposits, increasing investment, and boost economic development. Mentioned issues will be related to benchmark models like LIBOR (London Interbank Offered Rate) in a case of fixed return rate and a question of risk management possibilities in Islamic finance in cases of profit-loss sharing products. Finally, a possibility of use of some forms of financial derivatives is analyzed in order to safeguard depositors from loss on profit-loss sharing deposits.

Introduction

Economic development could be considered as a main criteria in differentiating between prohibited interest - *riba* and a trade compliant to Islamic *Shariah* law. Economical issues are not dealt in details in textual sources of Islamic *Shariah* law – Qur'an and Hadith, but they are left to be subject of rational judgement, guided by general moral principles outlined in textual sources and a few direct instructions. A question of an action being good or bad is by scholars of *usuli-fiqh* (principles of islamic jurisprudence) subjected to three criteria: universality, benefit of this world and benefit of hereafter. Issues of worship are exclusively judged according to the third mentioned criteria and described and sanctioned in details in textual sources. Economic transactions are judged according to benefits of this world if they fit into moral framework of Islam. Among those benefits, a significant position belongs to economic development, which is important factor of wellbeing of society.

Economic transactions are positioned between two border cases: swap of goods with real value (benefit) with consent and satisfaction of two parties on one side, and betting where one party takes possession of other party without giving anything in return. Somewhere between those two border cases is a line which divides trade and prohibited interest. Transactions disconnected from economic activity and increase of benefits of society, are considered as *riba* transactions. Those transactions are in essence close to betting and gambling, where the core issue is exploitation, taking something from somebody without giving counter value. Modern financial institutions are therefore operating on *riba* basis. As an illustration of their disconnection from real economic activities can serve a fact that a volume of financial transactions is 50 times bigger than volume of world trade (Ayub, 2007).

Islamic banks or Islamic financial institutions are founded with an aim to provide profit-loss sharing models. However, there is no actual difference between operations performed by Islamic banks and operations performed by other commercial banks. The key financial product of Islamic banks is *murabahah* in its different forms, especially commodity *murabahah*. More than half of the volume of banks operations in Malaysia, or about 51% of all cash transactions in Malaysia in years 2007 and 2008 is performed through *murabahah* contracts, with additional 15% through the way of *bay al-innah* (the special form of commodity *murabahah* allowed in Malaysia), which together is 65% or two thirds of total volume of transactions. (<http://mpira.ub.uni-muenchen.de/20262/>)

Murabahah is a transaction in which bank or financial institutions buys commodity (usually at request from customer) and then sells it to a customer for higher price, which can be paid in installments or on agreed time. In this way customer can attain goods which he needs for his business or personal use. In a case in which goods are used for business, this kind of *murabahah* has its economic justification.

Commodity *murabahah* is a way to obtain cash, instead of goods. Commodity is purchased on a deferred price, and sold to a third party to obtain cash. This kind of *murabahah* is also called *tawarruq*. Organised *tawarruq* includes bank as an agent in transaction. Bank sells a commodity to third party for a lower spot price, and two transactions are usually performed simultaneously, without actually acquiring goods. In this way, buying and selling commodity covers the basics of transaction, which is very similar to classical credit given by banks charging interest for deferred return of money.

There is much controversy about this transaction. The International Council of Fiqh Academy, which is an initiative of the Organization of Islamic Conferences (OIC), in its 19th session which was held in Sharjah, United Arab Emirates, from 1 - 5 of Jamadil Ula 1430 AH, corresponding to 26 – 30 April 2009, declared organized *tawarruq* impermissible. (<http://www.isra.my/fatwas/treasury/interbank/tawarruq/355-oic-fiqh-academy-ruled-organised-tawarruq-impermissible.html>.) with a rationale that it is considered deception, in order to get the additional quick cash from the contract, and therefore containing the element of *riba*.

Some scholars argue that *tawarruq* should be allowed. Mohammad Akram Laldin, a religious scholar from Malaysia, disagreed with the ruling of Fiqh Academy. (<http://www.arabianbusiness.com/557758-islam-allows-organised-tawarruq-asset-sales---scholar>) In his opinion organised *tawarruq* does not violate Islamic law principles, and there is nothing wrong with the transaction itself. However, he admitted that organised *tawarruq* focuses on the creation of debt rather than an economic activity, and that Islamic finance must provide a balance between debt instruments and equity based instruments.

Sheik Nizam Yaquby holds to idea that also said there were hardly any alternatives to *tawarruq* as a tool to satisfy legitimate financing needs. (<http://islamicfinancenews.wordpress.com/category/products/tawarruq/>) He expresses support for the standards of Bahrain-based AAOIFI — the Accounting and Auditing Organization for Islamic Financial Institutions — which in his opinion provided the necessary checks to prevent the abuse of *tawarruq*.

Strongest points for impermissibility of *tawarruq* were forwarded by **Mohammad Nejatullah Siddiqi**. (http://siddiqi.com/mns/Economics_of_Tawarruq.pdf) In his paper Economics of Tawarruq he performed macroeconomic analysis and proved that the harmful consequences of *tawarruq* are much greater than the benefits claimed by supporters of such practice. That paper preceded ruling of Fiqh academy and cited views of scholars, but on the other hand could be considered last saying concerning this issue.

The main problem of every *tawarruq* transaction is creation of a debt, which is larger than the cash it transfers to the client. Furthermore, debt document resulting from *tawarruq* is a subject to financial and speculative transactions, which cut links with real assets, resulting in a reversed pyramid – a huge quantity of financial instruments relying on a very small asset base. The economy then becomes focused on benefiting from consumption of debt.

Therefore, Siddiqi summarized the harmful effects of *tawarruq* as follows:

- It leads to creation of debt whose volume is likely to go on increasing.
- It results in exchange of money now with more money in future, which is unfair in view of the risk and uncertainty involved.
- It leads, through debt proliferation, to gambling like speculation.
- It leads, through debt finance, to greater instability in the economy.
- In a debt-based economy, the money supply is linked to debt with a tendency towards inflationary expansion.
- It results in inequity in the distribution of income and wealth.
- It results, through debt finance, in inefficient allocation of resources.
- It contributes, by consolidating debt financing, to raising anxiety levels and destruction of environment. “

Some classical jurists considered *tawarruq* as permissible, and Siddiqi rightly points that the tools of macroeconomic analysis were not available to them, and consequently they could not consider the harmful impact (*mafasid*) of *tawarruq* on the economy as a whole, while its benefits (*masalih*) for some individuals were easy to see. Very strange is however, that some contemporary scholars are closing their eyes to economic tools that are available to them, and neglecting arguments that were not available to classical scholars.

Indeed, voices supporting *tawarruq* practice are tinny. Even if practice itself does not contradict Islamic law, which is not the case, its harmful consequences are sufficient reason for its prohibition. When economic development is considered, it is obvious, that *tawarruq* practice should be discarded.

The consequent issue is: what is an alternative to *tawarruq*? An alternative proposed by OIC Fiqh Academy to *tawarruq* (and other *murabahah* transactions) is *qard hasan* (benevolent credit). This alternative does not sound realistic. *Qard hasan* is an act of charity, and it is hardly to believe that there is a huge number of money owners who are willing to act in accordance with this high moral virtue. No question that such a form of money lending exists in practice, especially between relatives or close friends, but on a big scale, and as a policy which should provide economic growth, it does not give much sense. In the case of financial institution, it should work for free, taking deposits from depositors and giving them to customers, where depositors bear risk of not returning money and not getting any profit.

A shift from *murabahah* practice and debt instruments must be made in the opposite direction. Instead of giving money with no profit at all, banks should turn to equity-based financing which could provide higher return for money depositors. However, a known fact is that higher return is connected to higher risk (Hull, 109).

Mudarabah contract is an example of activity which can bring higher return, but carries higher risk too. In such a contract bank will provide capital for the project, while entrepreneur will provide expertise and work to carry the project. Contract defines share of each party in the profit, and bank usually bears all financial risks.

This type of contract is attractive for Muslim investors, who obey principles of Islamic law for two reasons: it is compliant to *Shariah*, and it brings profit. On the other hand, this type of financial model could mobilize some other funds. A possible return rate for investors is much higher than LIBOR (London Interbank Offered rate) rate. LIBOR rates are short-term lending rates offered by banks in the interbank market (Hull, 94), and they are considered by financial derivative traders to be the best proxy for risk-free rate. They regard LIBOR as they opportunity cost of capital. It is approximately equal to short-term borrowing rate of AA-rated company regarding credit return ability. As a consequence of higher return rate from investing in *mudarabah* contract it can be attractive to arbitrageurs, who can see an opportunity to borrow money at risk-free rate and investing it in Islamic bank.

A shift toward risk-sharing models (profit-loss sharing models) requires from banks to take an active role, because an emphasis is on real economic activities rather than some artificial arrangements. A well done risk management is necessary for operating bank activities. By analogy to analysis of *tawarruq* and debts instruments arising from it, as well as their harmful role to economy, risk management by use of options should be avoided. Consequently, Islamic banks must rely on third-parties guarantees and *takaful* – Islamic form of insurance in order to mitigate risks arising from *mudarabah* and other types of equity-based transactions. On the other hand, banks themselves should develop models for minimization of risk. This includes diversification of economic branches in which investments are made. Banks will need an expertise in every branch, which is chosen for possible investment. An expertise would be useful particularly for choosing entrepreneurs which are reliable in business. Finally, Islamic banks must ensure sustainable operation by allocating a ratio of profit to make own security funds, so that reliance on third parties guarantees decreases by time.

Conclusions

Judging by criteria of Islamic law and economic development *murabahah* practices including commodity *murabahah* or *tawarruq* should be avoided. Islamic banks should shift to more risky forms of equity-based financing such as *mudarabah*. Such a shift demands an active role of Islamic financial institutions in risk management through diversification of investments, investigating entrepreneurs and obtaining an expertise in the areas of investment.

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<http://mpa.ub.uni-muenchen.de/20262/> MPRA Paper No. 20262, posted 26. January 2010 / 17:38

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