ISSN: 2162-6359

International Journal of Economics and Management Sciences

MANAGEMENT JOURNALS
managementjournals.org

Vol. 1, No. 1, 2011, pp. 82-86

AN ISLAMIC MODEL OF INTEREST FREE BANKING

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ABSTRACT

Our objective is to analyze the working of an interest free economic system. We will first present the model of interest free financial system as developed by Uzair, Siddiqui and Ahmed. Later we will discuss the implications of our work for the model of Islamic financial system as developed by the above authors. The discussion will be followed by comments on the feasibility of the model. Since the process of islimization is apparently going on for several years, specially in the direction of interest free financial system, any discussion on Islamic financial system would be incomplete without the mention of the experience of these financial institutions .we will therefore give a brief description of these efforts in general and in particular Pakistan's experience would be discussed at length. Our main concern in case of Pakistan bank, a financial institution that has introduced various Islamic financial schemes. The article concludes with a brief outline of some unresolved issues and suggestions for resolving these issues.

Keywords: *Interest free banking*

INTRODUCTION

The Islamic economists and jurists seem to have agreed that the mudaraba types of financial transactions are legal of Islam. Thus they propose that these contracts would be the primary basis for replacing the present banking system. Uzair, Siddique, Ahmed and others have developed the model of interest free banking, which is our focus in this section. Uzair's description consists of three parties involved in the system, namely, a) the actual users of capital, or the entrepreneur, b) the bank which serves as a partial user of these funds and as an intermediary, c) the suppliers of funds i.e. the depositors with the bank.

METHODOLOGY

There are two contracts involved in the process. The first between the supplier of fund and the bank and the second between the bank and the investors. The bank will receive the deposits of various kinds from the public on the basis of mudaraba and will share the profit/loss with them on the basis of certain mutually agreed terms. The bank will enter into a mudaraba/ partnership contract with the depositors in accordance with the nature of their deposits. It will issue them certificates of partnership or treat them as mere account holders. The bank will use these funds by advancing loans to individual businessman or firms on the same principle of profit/loss sharing.

In these triangular relationship-princiapal-mudaraba banks-entrepreneur- the bank will have direct contact both with the principal and the investors. The mudaraba bank and its shareholders will share the profit/loss with the enterprise i.e. the mudaraba bank after sharing profit/loss with the investors will share its performance with its depositors.

The standard conditions of Mudaraba contract

Siddique (1979) has discussed the determination of equilibrium profit sharing ratios between depositors and bank on one hand and between the bank and the investors on the other hand. He assumes competitive behavior on the part of each of the three sets of agents. He defines the "depositors' rate of profit" (DRP) as that percentage of banks profits which is given to depositors and "Bankers rate of profit" (BRP) as that percentage of investors profits going to the bank.

He then defines P as the expected rate of profit to the investors. He postulates that the demand for mudaraba funds by the investors is a decreasing function of BRP. Given certain amount of savings, S, in the bank the supply of mudaraba advances is an increasing function of BRP. The equilibrium BRP is determined, a given P and S, by the intersection of demand and supply of mudaraba funds.
An increasing in P would increase the demand for mudaraba funds and given S, this would cause an increase in BRP. This in turn with some lag would probably lead to a higher S, depressing BRP to its original level. An increase in S would increase the supply mudaraba funds and for a given P this would mean decease in BRP, leading to a greater volume of mudaraba advances.

On the other hand the supply of deposits by the savers is a direct function of DRP offered by the bank, whereas savers face a nearly perfectly elastic demand their deposits. The equilibrium volume of savings is thus determined on the supply side of the market. An increase in BRP or P will increase the quantity supplied of deposits.

Siddiqui argues that both BRP and DRP will rise in response to an increase in P, as bankers will have to compete with the non-bank alternatives of investment which would become more attractive in that situation. They might fall together as P falls continuously, but the DRP may lag behind BRP because of banks eagerness to sustain a supply of bank deposits which enables them to induce demand for advances by accepting a lower BRP. Thus DRP may be more stable in the long run than BRP.

Siddiqui then goes on to argue that the savers will not be exposed to short term fluctuations in the P, the investor's rate of profit. In particular he maintains that DRP is even more stable than P. The idea is that with the change in P, in order to compete with the share market for supply of funds banks have to read just DRP in the same direction. On the other hand they would tend to maintain a stable rate of return on deposits sufficient to ensure the desirable supply of funds." For banks as profit maximizers sustaining the supply of savings is for more crucial than rates of profit sharing, especially when operating with fractional reserve system. The rate of return on deposits may be rise in boom in sympathy with the rising profitability of investment outside the bank but a sound banking policy will resist a downward movement in this rate during a slum as a sizeable contraction in supply of bank deposits may be disastrous for the banking system, which can always hope in a system of profit sharing to revive demand by accepting a lower BRP."

Uzair has presented the working structure of an Islamic bank. The funding operations of Islamic banks consist mainly of a) Investment deposits and b) current account deposits. The former corresponds to the "fixed or time deposits" of the present financial system. Since the primary motivation of the depositors in this account is earnings of profits, funds in this account can be invested on the mudaraba basis. The funds are pooled before the investment is made. Bank shares the profit with the depositors on its overall performance. Thus the depositors may actually end up loosing their funds if the bank suffers a loss from its overall operations. Savings accounts are also treated in the same manner as the investment accounts, although funds in this account are not solely motivated for a desire to earn profits.

Currents accounts deposits are held for transaction purposes. Banks provide services of checking, overdrafts, and like to the holder of these accounts, on payment of a service charge. The depositors in this account don't earn any return. Funds in this account cannot be used for by the banks to finance investment projects. But legally banks can give loans to some companies to meet short-term liquidity problems. On the lending side of operation of banks several instruments are available for long-term investment projects but there are problems in devising instruments for short term financing. In the traditional financial system business raises funds mainly through the issuance of equity shares, debentures, or by medium and long term borrowing from the banks at the current interest rate. In the Islamic bank the latter two possibilities are excluded.

The major source of industrial finance under Islamic financial system is equity financing since it conforms to Islamic principle of profit/loss sharing. Therefore under such a system the banks or other financial institutions provide funds to the industry by becoming a partner in the investment project or by buying shares of the company. In most of the cases the funds constitute redeemable capital of the firm.

It seems that there will be no problem either in the implementation or in the functioning of such a system as far as the long-term financing of industrial projects is concerned. But the real and challenging problem arises when we look at the structure of short-term finances to industry under such a financial system. The demand for so-

called "working capital" is a sizeable proportion of total finances to industry and constitutes an important part of modern banking and financial system. Since the present system provides such finances on the basis of a fixed interest rate the problem is to see how an Islamic bank, where interest is prohibited, would handle this type of transactions.
Ahmed (5), and Rehman (7), have suggested that these short-term finances should be provided free of charge. However, Uzair maintains that such a proposal is not viable. He argues that any assistance from the bank requires incurrence of certain cost for which it must be compensated.

Since the party receiving this type of assistance would normally be getting some benefits, bank should not go un-rewarded.

Uzair categorizes these loans as follows:
a) Short term loan for one year or quarter there off.
b) Short term loans for one to three months.
c) Short term loans for one month or less.

For (a) it is suggested that profit sharing should be the basis of rewarding banks since many firms can and do determine their profitability during such periods for internal purposes. In case it is not done then some fraction of annual profit rate should be applied to the period for which loan is made.

In case of (b) either annual rate should be used or in case earnings can be estimated correctly, like in case of financing imports or purchase of other goods, earnings can be figured out from the difference between sale and purchase price, profit should be the basis.

In case of (c) Uzair suggested that a service fee should be charged per transactions. "This service charge on per transaction basis", Uzair argues "will be different from interest rate because it will not be tied down to length of time within one month or to the amount borrowed."

The loans to agriculture sectors are primarily in the nature of short-term loan. These loans are usually provided by special agricultural banks or cooperative societies. The access of conventional commercial banks to the rural population is sometimes rather limited, particularly if peasants are skeptical about modern banking techniques and if because of maximum lending rate limitations, high administrative costs and excessive default risks banks find such activities unprofitable.

Under these circumstances a financial system endorsed by the religions leaders could be very helpful. The same principle of profit sharing could be applied to either the output of the farm or to the actual profits.

Banks can participate in agricultural activity in several ways:
(i) By supplying inputs to the farmers, (ii) by financing the purchases of inputs, (iii) providing liquidity at the crucial stage of harvesting or (iv) extending facilities which would help in achieving the efficient marketing of the farm output. It is hoped that, through this participation is complex, it will be highly rewarding. The optimism is based on the fact that the bank by becoming partner with several farmers can internalize several externalities which exist in small farm operations like funding labor during harvesting, the mark up occurring to the middle man for marketing thus reducing farmers profit, high input cost etc. Profit participation may also help improve the supervision of loan which is poor under interest based loans.

Another difficulty faced by the Islamic bank is in the provision of consumer credit. In the modern banking system consumer credit again plays an important role. There is a variety of loan available for this purpose including loans for housing, auto, and purchase of other consumer durables.

Islamic Economists, at the outset, point out that in an Islamic society people should not live beyond their means and that no conscious effort on the part of producers or financial institutions will be allowed to create the demand for consumer durables which is the basic cause of living beyond means.

Many Islamic Economists have suggested that these loans should be provided without any charge. These loans are mostly needed for the purposes other than profit earnings. These should be in the nature of what Islam calls, "QURZ-E-HASANA", welfare loans. This however is not a feasible solution when one looks at the basic motivation of business enterprises under normal conditions. Thus other Muslim scholars believe that these loans are productive in the sense of enhancing one's abilities to live a better life, if not productive in the direct sense of yielding immediate profits.

However, there are extreme difficulties in devising remuneration mechanism for these loans that are consistent with Islamic principles of finance. Uzair thinks that under this new system only a small fraction of people will approach commercial banks if employers extend these loans to their employees. The residual demand can be met by the banks through financing purchase of consumer durables and participating in profit loss with the producers. Bank can again charge a small service fee from the borrowers in order to meet the administrative expenses. The loans for housing can easily be extended on the basis of profit sharing by sharing in the ownership of house and the rental value until the loan is repaid.

However, there still exists a demand for consumption loans, which cannot be met through above arrangements. Mannan (8) has suggested organizing people's credit cooperatives for this purpose. This organization requires its members to purchase shares of certain amount. The funds so obtained are then granted to its members as consumption loans. The loan is payable in installments. Ahmed (5) has suggested that expenses of organization should be met through a tax on each consumption loan made. If some of the funds are unused then these will be invested in profit yielding ventures.

CONCLUSION

In the preceding section we have presented a theoretical as well as a working model of interest free banking. We now critically examine it in the existing literature on the theory of money and banking.

An immediate impression which is fairly easy to draw is that no effort has so far been directed in rigorously investigating the implications of such a system, (9).

WE BELIEVE THAT SUCCESSFUL IMPLENTATION OF INTEREST FREE BANKING REQUIRES A CLEAR UNDERSTANDING OF ITS MERITS AND DEMERITS COMPARED TO THE PRESENT SYSTEM.

One needs an analytical framework which allows the comparison of the two systems.

IT IS DIFFICULT TO BELIEVE THAT THE PRESENT SYSTEM, THROUGH UNISLAMIC, IS ENTIRELY WITHOUT MERIT IN AS MAUCH AS IT SATISFIES THE NEEDS OF THOSE ACTIVELY ENGAGED WITH IT. KNOWLEDGE OF ITS METITS WOULD HELP EVOLVE A SYSTEM THAT WOULD TAKE INTO ACCOUNT THESE MERITS AND ASSIMILATE THEM INTO AN ISLAMIC FRAMEWORK.

If this is not possible i.e. if one of the merits run against the spirit of Islam, then the resulting costs of abandoning this merit must be explicitly indicated.

The following comments are a reflection of the above theme.

It is clear that Islamic banking is more in the nature of investment banking. This is the predominant activity of the banks. There are several institutions in the modern system, which perform an identical role (like the money market funds institutions). This however does not mean that banks would not perform usual commercial transactions but only that there has to be a sharp distinction between the two activities

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