The Basis of Islamic Banking & Finance

Unit

2

Unit 2

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Introduction

Learning outcomes

By the end of this unit the learner will be able to:

- **Discuss the Philosophy of Islamic Finance**
- **Identify the alternative financing principles**

Islamic banking and finance has been conceived as banking and finance in consonance with the ethos and value system of Islam. Hence, it is governed, in addition to the conventional good governance and risk management rules, by the principles laid down by the Islamic *Shari'a*. In the 1980s, the term "interest-free banking" was used to describe an alternative system to the conventional interest-based system. But the term "interest-free banking" is a narrow concept, denoting a number of banking instruments or operations which avoid interest. Islamic banking, a more general term, is expected not only to avoid interest-based transactions, but also to avoid Gharar, also prohibited in the Islamic *Shari'a*, and other unethical practices and to participate in achieving the goals and objectives of an Islamic economy.

The above nature of business demarcates the philosophy and features of the emerging discipline in the world of finance. In this unit we shall be discussing the basic features of Islamic finance directly affecting the products, instruments, institutions and markets in the framework of business and finance. This includes avoiding interest, involvement in genuine trade and other business, Kharaj bi-al-Daman and other requirements for profit entitlement in various kinds of businesses, money earning money versus risk-based business and their impact on banks, depositors and the fund users.

The Philosophy of Islamic Finance

Islamic economics, of which Islamic finance is an important part, is broadly based on some prohibitions and encouragements. The prohibition of Riba and permission to trade, as enshrined in verse 2: 275 of the Holy Qur'¯an [Allah has allowed (profit from) trade and prohibited Riba, drive the financial activities in an Islamic economy towards asset-backed businesses and transactions. This implies that all financial transactions must be representative of real transactions or the sale of goods, services or benefits. In addition, Islam has also prescribed a moral/behavioural standard that is almost common in all civilized societies of the world.

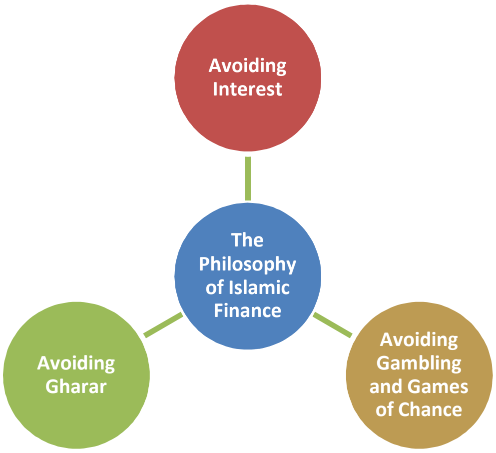

Fig: 2.1

The structure of Islamic finance revolves around the prohibition of any return derived on a loan/debt (Riba) and the legality of profit. Riba – commonly known as interest – is an increase taken as a premium from the debtor. It represents the return on transactions involving exchange of money for money, or an addition, on account of delay in payment, to the agreed price on sale debts/debts. The *Shari'a* has prohibited it as it generates imbalances in the economy. As all transactions involving interest payments are strictly prohibited, debt contracts cannot be sold at a premium or discount, and exchange transactions of money or goods representing money like gold and silver must be equal for equal and hand to hand.

While the term "equal for equal" is obvious, meaning that any increase on one side would be Riba, the exchange of money as business must also be hand to hand, because otherwise, a person can take benefit by the use of money/currency which he has received while he has not given its counter value from which the other party could take benefit.

In the context of Islamic finance, a loan will be considered only a monetary or financial transaction where only funds exchange hands with a guarantee for repayment in full without any return for the creditor. It will not be considered an investment. Investment in the Islamic context is not merely a financial or monetary transaction in which the transfer of funds is the only activity. Investment will be considered only if it becomes a part of real activity or is itself a real activity. Thus, purchasing a bond issued by a government or corporation or making a deposit in a conventional bank in the form of a loan will not be considered investment, because they are merely financial transactions and no real activity is involved.

However, if the funds are used to purchase real goods or services and then sell them on at a profit, this use of funds will be treated as investment. But using the funds borrowed on interest for buying or building a physical asset is not a permissible activity. Similarly, buying and selling a financial document will not be an investment because no real activity by the holder is involved in this exchange. As such, while earning on loans is prohibited by virtue of it being interest, any return on investment is permissible and allowed.

In loan transactions, the exchange must be of equal amounts. If the borrowed commodity is fungible, as currency notes are, exactly its like is to be repaid; and in the case of non fungible goods, the loan contract will be made in terms of money. In the case of two similar goods, the condition of excess payment of either is prohibited, even when it is a transaction of sale, not a loan. The excess has been termed Riba. Thus, if one ton of wheat or 1000 dollars are borrowed, one ton of wheat or 1000 dollars will be repaid; any excess shall be usurious.

Currency notes represent Thaman (price) and trading in Thaman has been declared by the holy Prophet (PBUH) as usurious except when exchanged hand to hand and also equal for equal (in case of similar currencies).

In addition to the negation of interest, Islamic finance does not approve involvement in excessive risk-taking or any games of chance that also lead to exploitation and loss to both or any of the parties to the contracts and to human society as a whole. One should sufficiently know what one is giving and what one is getting in exchange in a contract. This implies that certainty about the subject matter and its exchange value, transparency, disclosure and free consent of the parties for entering into the contract are the important factors in Islamic business and finance. A number of principles and rules stem from the above given philosophy of Islamic finance and these are discussed below.

Avoiding Interest

Keeping in mind the two verses of the Holy Qur'¯an (II: 275, 279), jurists and *Shari'a* scholars have developed a criterion that serves as a fundamental building block of the Islamic theory of finance and economics. The most important feature of that theory is avoiding interest or any *extra* return derived on a loan/debt (Riba). The lender, according to *Shari'a* tenets, has to give away the lent goods/money to the borrower for the period of the loan without seeking any worldly compensation. Therefore, Islamic banks will not take or give any loan or enter into contracts seeking any increase over the principal of loans or debts created as a result of any credit transaction. Buying/selling goods, both on cash payment and credit, for the purpose of earning profit is permissible. Pricing the goods, keeping in mind the time given for payment of the price in credit transactions, is also acceptable with the condition that it should not involve any addition or enhancement to the principal amount of the debt created as a result of the sale transaction.

This implies that once any debt is created, the seller cannot demand more than the credit price stipulated in the sale or other contracts.

Avoiding Gharar

Avoiding Gharar is another main principle of Islamic finance. Gharar, refers to entering into a contract in absolute risk or uncertainty about the ultimate result of the contract and the nature and/or quality and specifications of the subject matter or the rights and obligations of the parties. Gharar is also involved if there is a lack of adequate value-relevant information (Jahl) or there is inadequacy and inaccuracy of any vital information which leads to uncertainty and exploitation of any of the parties. Deceit, fraud or deliberate withholding

of value-relevant information is tantamount to Gharar. Islamic banks should not engage in any bargain in which the result is hidden, as they would not be certain whether the delivery could or would be made, which is necessary for the completion of any genuine business transaction.
The current practices of financial institutions and insurance companies in the futures and options markets are un-Islamic because of the elements of Gharar, interest, gambling, etc. The transactions of contemporary stock markets, if cleansed of these elements, would be Islamic.

The prohibition of Gharar requires Islamic banks not to engage in speculative trade in shares, short-selling, discounting of bills and securities or trading in unidentified items. Similarly, Islamic investment banks' involvement in IPOs of joint stock companies would require care to avoid Gharar, as information asymmetry between the investors and promoters in the early stages of companies' establishment may involve Gharar. Trading in derivatives also involves Gharar and, therefore, is a grey area for Islamic banks.

Avoiding Gambling and Games of Chance

Another kind of activity which IFIs have to avoid is gambling/games of chance. All instruments like prize bonds or lotteries in which coupons or tabs are given and inducement or incentives are provided by an uncertain and unknown event depending on chance, or disproportionate prizes are distributed by drawing of lots or where the participating persons intend to avail themselves of chance at prizes are repugnant to the injunctions of Islam. Similarly, a scheme wherein the investors' money is safe and intact, but the prizes to be given are related to interest generated from capital accumulated through it, does not conform to the injunctions of Islam due to involvement of both Riba and Qim¯ar.

Gambling is involved in a number of financial transactions and conventional banks' schemes/products, which Islamic banks have to avoid. Conventional insurance is not *Shari'a*-compliant due to the involvement of both Riba and Maisir. Governments and public/ private sector corporations mobilize resources on the basis of lotteries and draws, which come under the banner of gambling and are, therefore, prohibited. Present futures and options contracts that are settled through price differences only are covered under gambling. More relevant to the discussion in this regard are lotteries or prize-carrying schemes/bonds that conventional institutions launch from time to time. This is because only a small number of the participants of such schemes get a prize at the cost of other bondholders, without undertaking any liability or doing work for it.

Alternative Financing Principles

In the absence of interest as a basis of financing, Islamic banks have a number of techniques and tools to do their business. Briefly, they will invoke the participation and sharing principle applicable in Musharakah, Mudarabah and their variants, the deferred trading principle applicable in respect of credit and forward sales (Mu'ajjal and Salam), a combination of techniques like Shirkah and Ijarah, Murabaha and Salam/Istisna'a, etc. and return-free loans in specific situations and in consultation with various stakeholders.

Below are given the major forms of Islamic finance with respect to the philosophy of Islamic banking:

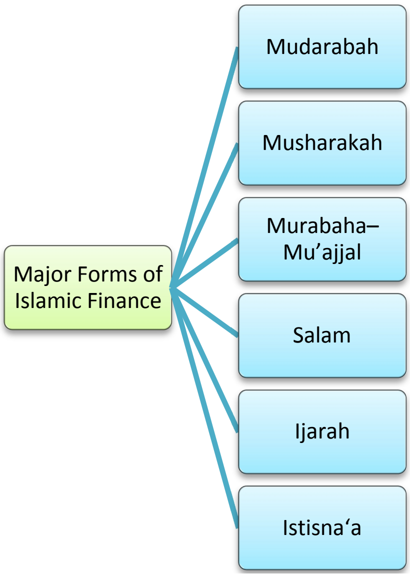

Fig: 2.2

1. Mudarabah is a partnership arrangement in which one party provides capital to the partnership while the other party provides entrepreneurial skills. Any loss is borne by the financier; any profit is shared by the partners according to a pre-agreed ratio.

2. Musharakah, another PLS arrangement, may take the form of a permanent equity investment, a partnership in a specific project having a fixed duration or a diminishing partnership (the bank's share is reimbursed over time by the company acquiring funds), especially for housing and other fixed asset financing that could be leased.

3. Murabaha–Mu'ajjal involves acquiring goods upon a customer's demand or otherwise and their credit sale at a profit margin. It results in debt covering the cost plus a profit margin. This debt has to be paid back irrespective of profit or loss to the person or institution that purchased on credit and suffered loss or the wares destroyed in his ownership. To this effect, we come across a very important reference relating to the period of the second Pious Caliph of Islam Umar (RA). As reported by Ibn-e-JarirTabari (d. 310 AH),"Hind bint-e Utbah came to Umar and asked for a loan of 4000 (dinars) from the public exchequer so that she could trade with it and became liable to pay back the same. After getting the amount, she went to the area of banukalb and engaged in trading; but she suffered loss. Umar (RA) said the loan could not be waived as it was from the public exchequer.

4. Salam involves providing funds against the forward purchase of precisely defined goods with prepayments.

5. Ijarah involves leasing an asset and receiving rentals; so long as the asset is on lease, the lessor owns the asset and the risk and reward of its ownership.

6. Istisna'a involves engaging a person that could also be a financing agent to manufacture or construct and supply an item at some future date for an explicit sum on periodic payment. The agent contracts with a manufacturer to produce the commodity and the customers make payments to cover the production price and the profit margin.

The rate of return for the banks is known in credit sales like Murabaha, Musawamah and in Ijarah. However, the risk profile of trade and Ijarah is different and in the case of the latter, the bank will have to bear the asset risk and the ownership related expenses. The net return in Ijarah would, therefore, be quasi fixed.

The return is basically unknown in Salam and Istisna'a, as the bank cannot ascertain in advance the price at which it will sell the asset when delivered under these contracts. But it could be known to the bank to some extent, with the possibility of any change in income, if it enters into a parallel contract or a promise with any party for disposal of the asset at any stipulated price. If the promisor is unable to purchase the asset for any reason, the bank's income will certainly be affected. In the case of sharing modes, the return rate is not known in advance.

Security/Collateral

In all debt-creating modes, banks may ask the client to furnish security in the form of a mortgage, a lien or a charge on any of his existing assets. In a forward purchase, banks can ask the client to furnish security to ensure that he shall deliver the commodity on the agreed date. In PLS modes, the bank can also ask for security against the nonperformance of the contract. But the bank is not entitled to enforce the collateral in the case of loss in the business if loss has occurred without any misconduct or negligence on the part of the client partner.

Liquidity

The feature of liquidity means the possibility or ease with which the bank can sell the related assets to get cash when needed. As Murabaha receivables cannot be sold like debt instruments are sold in conventional finance, they are considered non-liquid assets. The same is true of Salam and Istisna'a. Assets or instruments representing assets in Ijarah or sharing modes are liquid because the same can be sold in the secondary market.

Valid Gains on Investment

All gains on investment or principal of a business are not prohibited. On the basis of the overall principles indicated by the *Shari'a*, scholars have identified methods of gainful deployment of surplus resources with the objective of enhancing their value. Profit has been recognized as a "reward" of capital and Islam permits gainful deployment of surplus resources. The *ex post* profit, allowed by the *Shari'a*, symbolizes entrepreneurship and the creation of additional wealth. However, along with the entitlement to profit, the liability of risk of loss rests with the capital itself; no other factor can be made to bear the burden of the loss on capital.

Financial transactions, in order to be permissible and for the purpose of earning profit, should be associated with tangible real assets. In the Islamic framework, money itself is not recognized as capital, and as such it cannot earn a profit in itself. The provider of funds is an entrepreneur as well. He will get a profit/loss for his capital and a wage/remuneration for his entrepreneurship/labour. If he does not manage the business himself and provides capital to any other individual/group of individuals for any business, he will have a share in the profit while the manager of the business will get "wages" in the form of a share in the profit.

But if the business suffers a loss, the capital owner will bear the loss while the manager's labour will go wasted. Thus, earning of profit, depending upon the outcome of the business, is permissible. Keeping in mind this principle, it can be said that one can earn profit on his investment or financing but that has to be related to certain assets exposed to direct or indirect business risk.

All Pre-fixed Returns are not Riba

It is also not necessary for the sake of Shari'a compliance that income from any investment/ transaction should be variable. In a number of structures it could be fixed and even then Shari'a compliant. To ascertain the Shari'a position of any types of transaction, we will have to look at their nature. If it is a loan or a credit transaction culminating in a debt, such loans/debts cannot fetch any increase whatsoever. In the sale of goods or their usufructs, however, one can make a profit as per the rules of the Shari'a relating to the respective transactions. In trade, a person can sell any commodity, not including money, for one price on a cash-and-carry basis and for a higher price on a deferred payment basis. Cash or credit prices in the market should be determined by market forces. However, this is subject to certain conditions, the fulfillment of which is necessary to differentiate between interest and legitimate profit. The following points may be kept in mind to differentiate various transactions in terms of deciding their permissibility or otherwise:

- Bai' (sale/purchase of goods) means the definite transfer of ownership of goods to the buyer against the payment of a price that can be on the spot, delayed (in a credit sale) or in advance (in Salam). The risk and reward relating to the sold goods will belong to the buyer, who will be required to pay the price irrespective of the manner in which he has used them or the profit/loss to him in business. As such, Islamic banks will have no recourse to the sold goods for the purpose of Murabaha rollover. The banks price the goods and the debt is created; now the goods belong to their clients, they have no right to re-price them.

- Hibah (gift) means the permanent transfer of ownership of assets free of any payment. After having given a gift, one cannot take it back except with the consent of the person to whom the gift was given.

- Riba (Al-Nasiah) means giving something or money temporarily to others' ownership against payment; this involves interest and is therefore prohibited. If this temporary transfer of ownership of goods/assets is free of any payment, it is called Qard al Hasan/Tabarru' and Islam encourages this activity.

- Ijarah refers to the transfer of the usufruct of assets against payment of rent. Rental is allowed subject to the condition that the lessor bears the risk and expenses relating to ownership of the leased asset. There should be no confusion in this regard about interest vis-à-vis the concept of rent in Ijarah (leasing). It might be argued, for example, that as per approved Shari'aprinciples, predetermined rent including a time value of money is allowed; therefore, a predetermined time value of money in loans/debts should also be permitted by analogy. This argument does not have any substantive basis. The rent in leasing is calculated on the basis of the capacity of the asset to give usufruct, which is, in principle, uncertain. Hence, it remains uncertain how much time value of money is actually realized until the asset has completed its economic life. The lessor, as owner of the leased assets, is also the owner of the risk and reward associated with that asset.

Further, anything which cannot be used without consuming its corpus during its use cannot be leased out, like money, yarn, edibles, fuel, etc., because when an asset no longer exists, how can the lessor bear the ownership-related risk? All such things/assets, the corpus of which is not consumed with their use, can be leased out against fixed rentals. As such, one can lease out his asset to others for use against fixed/stipulated rental(s). While aeroplanes, ships, houses, motor vehicles, etc. can be leased out against fixed rentals, money/goods representing monetary units, edible items, petrol, etc. cannot be leased out; such items can be sold/bought or loaned and in the latter case exactly their like has to be given back or repaid.

The above discussion implies that Islamic banks can charge a fixed profit if they engage in trading and leasing. In loaning, however, or in the case of any debt or receivable emerging from credit transactions, they cannot charge any amount over and above the amount of the loan or the debt once created.

Variable Rates on Investments

Partnership-based modes (Musharakah, Mudarabah and their variants, collectively called Shirkah) give variable returns to the investors. Shirkah is the major mode used by Islamic banks for mobilizing deposits and funds from savers/investors, who get a variable return based on the result of the business conducted by the banks with their funds. Use of these modes on the assets side would yield a variable return for the banks. However, products can be structured in such a way that investors get a quasi-fixed return. This is possible when Shirkah-based investment is attached to fixed earning modes like trade and Ijarah. Examples are Diminishing Musharakah on the basis of Shirkatul milk and securitization through Shirkah.

The business risk involved in Shirkah-based modes is more than the risk in trade or Ijarah-based modes discussed above. The partners of a business conducted on the basis of Shirkah are at liberty to determine, with mutual consent, the ratio of profit allocation for each of them. The loss to be suffered by each partner must be exactly in the proportion of his investment. As the risk is high, normally the profit is also high in such modes. A number of empirical studies have proved that Shirkah-based or equity financing is widely used in various parts of the world and has many advantages over debt-based financing. However, Islamic banks and financial institutions have not yet fully explored the potential of Shirkah-based investments.

Entitlement to Profit – With Risk and Responsibility

The assumption of business risk is a precondition for entitlement to any profit over the principal. The important Shari'amaxim: "Al Kharaj bi-al-Daman" or "Al Ghunmbil Ghurm" is the criterion of legality of any return on capital, meaning that one has to bear loss, if any, if he wants to get any profit over his investment. Profit has to be earned by sharing risk and reward of ownership through the pricing of goods, services or usufruct of goods.

Investment in the Islamic context is not merely a financial or monetary transaction in which transfer of funds is the only activity. Investment, both by banks' depositors and the financial institutions, will be considered only if it is a part of real activity or is itself a real activity. This is because money has the potential for growth when it joins hands with entrepreneurship. In itself, it is not recognized as capital and, therefore, it cannot earn a return.

In all economic activities there could be some commercial risk and one has to bear that risk for the validity of the profit or earnings. In other words, the return on invested funds that plays a productive role in any business is a factor in the willingness and ability to cause "value addition" and bear the risk of a potential loss in the business. Reward should depend on the productive behaviour of the business where funds are used, implying that interest, lotteries, gambling, etc. are prohibited, because return in respect of them either does not accept the business risk or is based on pure luck, chance or hazard.

In debt-creating modes, Islamic banks will face credit/party risks, ownership transfer risks, market risks, commodity risks, price or rate of return risks, legal and documentational risks and other mode-specific risks. Remaining within the Shari'a principles, Islamic banks are allowed to take risk mitigation/management measures. Hence, risk can be mitigated but not totally eliminated. Transfer of commercial risk to anyone else without transferring the related reward is not permissible.

The principle is that ownership cannot be separated from the risk of related loss. This has important implications for various transactions. In loans, there is no entitlement to any profit because the creditor gets back the full amount, irrespective of the nature of use by the debtor or the fact the debtor incurred loss in his business which he undertook with the borrowed money. In trade, so long as the asset remains with the seller, he has to bear the risk of its destruction; as soon as he sells it, the risk is transferred to the buyer and in the case of a credit sale, the buyer has to pay the price at the settled time even if the asset is destroyed for any reason. He can mitigate the risk by way of Takaful but it will have no link with his liability to pay the price. In Ijarah, the lessor is entitled to rent only when he keeps the asset in usable form by incurring ownership-related expenses and undertakes the risks associated with the asset.

Islamic Banks Dealing in Goods not in Money

Conventional banks deal in money: they get money from the public as loans and pay them interest; they give advances to needy people or firms in the form of money and charge them interest. In domestic or foreign trade financing activities or even in the case of finance lease, goods are also involved, but they have no concern with the goods or assets themselves; their main concern is with financing the purchase of goods and for that purpose they also deal in documents to facilitate the trading of goods. As such, there is a famous quote in conventional banking: “Banks deal in documents not in goods”. They undertake no responsibility or risk in respect of the subject of the contracts and their counter payments or price.

In contrast, Islamic banks deal in goods and documents and not in money. They use money only as a medium of exchange for purchasing the goods for the purpose of leasing or selling onward, thereby earning income or profit. In this process they also use documents for executing sale and lease contracts, keeping in mind the Shari’a principles and facilitating the operations.

The above discussion reveals that Islamic banks intermediate between savers/investors and fund users by involving certain goods and assets or papers representing ownership of real assets.

Transparency and Documentation

Islamic banks and financial institutions are required to adopt transparency, disclosure and documentation to a greater extent than the conventional banks. Lack of transparency in respect of Murabaha transactions, where Islamic banks are required to provide all details of the cost/price and the payment mode, may render the transaction non-Shar¯ı´ah compliant.

The Holy Qur’¯an enjoins us to write down and take witnesses in all transactions that involve credit one way or the other. Similarly, the holy Prophet (PBUH) himself encouraged disclosure of all features of goods being traded and the competitive environment in which people get sufficient information about goods and their prices in the market. The Islamic banks’ disclosure standards are stringent because their role is not limited to a passive financier concerned only with interest payments and loan recovery. Islamic financing modes are used to finance specific physical assets like machinery, inventory and equipment. Hence, clients of Islamic finance must have business which should be socially beneficial, creating real wealth and adding value to the economy rather than making profit out of antisocial or merely paper transactions.

An Islamic bank is a partner in trade and has to concern itself with the nature of business and profitability position of its clients. To avoid loss and reputational risk, the Islamic banks have to be extra vigilant about their clientele. Therefore, it is believed Islamic banks are less likely to engage in illegal activities such as money laundering and financing of terrorism than conventional banks.

Additional Risks Faced by Islamic Banks

Even though Islamic banks can genuinely take collateral for extending finance, they cannot rely on it heavily because of the risks associated with various transactions. They are, therefore, under obligation to carry out a more careful evaluation of the risks involved. The additional risks that Islamic financial institutions have to face are asset, market and Shari'a non-compliance risks, greater rate of return risks, greater fiduciary risks, greater legal risk and greater withdrawal risk.

Asset risk is involved in all modes, particularly in Murabaha (before onward sale to the client), Salam (after taking delivery from the Salam seller) and Ijarah, as all ownership related risks belong to the bank so long as the goods are in its ownership. In Shirkah-based modes, risk is borne as per the share in the ownership. Certain developments in the economy or the government's trade policy may affect the demand and prices of goods, leading to asset, price and rate of return risks. Receivables created under Murabaha cannot be enhanced even if the general market rate (benchmark) rises. In the case of non-Shari'a compliance, not only would the related income go to the Charity Account, but it may also lead to creditability risk for an Islamic bank, which in turn may lead to withdrawal risk and the "contagion effect" for the Islamic finance industry. Banks' involvement in physical assets may also lead to greater legal risks than the conventional banks have to face.

Debt versus Equity

After discussing the basic ingredients of Islamic finance, we take up some related aspects that will be helpful in fully understanding the philosophy of Islamic finance theory. It transpires from the above discourse that debt has to remain a part of Islamic finance. Islamic financial institutions, while providing a financial facility through trading activities, create debt that is genuinely shown in their balance sheets. So the issue is not one of "debt versus equity" but one of putting greater reliance on equity and subjecting the debt to the principle of Shari'a that debt, once created, should not increase on the basis of conventional opportunity cost theory.

In many areas of business, Shirkah-based modes either cannot be used or are not advisable, keeping in mind the risk profile of the investors. For example, a widow may require an Islamic banker to invest her money in less risky but Shari'a-compliant business because she is not in a position to bear the risk of loss that could arise in Shirkah-based business.
The bank, as a trustee, would be bound to invest funds of such risk-averse investors in trade and Ijarah-based activities. This gives rise to debt.

In line with the writings of the pioneers of the present movement of Islamic finance, many authors, both economists and financial experts, have been saying that Shirkah or equity based modes are the only modes which can serve as an alternative to interest in the Islamic framework. But this is not the case. Debt has existed forever, and will remain an important part of individuals' and nations' economics. The holy Prophet (PBUH) himself incurred debt, both for personal and also the State's requirements. The only point to be taken care of is that a debt should not carry "interest". Therefore, debt creating modes like Murabaha, Salam and Ijarah will remain as operating tools in the hands of Islamic financial institutions. The issue is not the permissibility of debt-creating modes, but a preference for equity-based modes over debt-creating modes.

Therefore, the aim is to create a healthy balance between debt-based and equity-based financing for the prosperity of the economy and society. An economy with a heavy reliance on debt could be highly risky. It is commonly said, for example, that in the US, personal and public debt has reached a point where it is a cause for concern with respect to the stability of the economy, a state which would have been reached already if not assisted by the twin factors of the US being the only super power in the world and the US Dollar being the reserve currency. The policies of the international financial institutions like the IMF, the World Bank and the WTO are also helping the US economy to survive, in spite of incurring heavy debts at the cost of the global economy.

Islamic Banking: Business versus Benevolence

Islamic banks do business just like their counterparts on the conventional side, with the difference of keeping in mind Shari'a compliance aspects. There has been a myth in some circles that Islamic banks need to work as social security centers, providing only return-free loans or charity to the needy and for benevolence. This myth has to be removed because business and benevolence are two separate things. Individuals have the right to spend for benevolence out of their income, for which they will be rewarded in the Hereafter as per Shari'a tenets. But the banks that hold depositors' money as a trust are not allowed to dole out the trust funds at their discretion.

Exchange Rules

Islamic banks' activities, as discussed above, involve the exchange of goods for money, which may take a number of forms like simultaneous exchange on the spot, spot delivery and deferred payment and spot payment with deferred delivery. For such exchange contracts, the Shari'a has advised exchange rules that are quite different from the rules applied in conventional finance, which are very flexible due to the absence of any Shari'a-related limitations. The most strategic difference between Islamic and conventional rules is that in the latter case, both items of exchange in a transaction can be delayed/deferred and the goods purchased and even the "options" sold onward without taking ownership of the underlying assets or possession of the related risk.

In Islamic finance, only one of the items of an exchange contract can be delayed and goods not owned or possessed cannot be sold. Exchange rules are different for different contracts and types of wealth. Goods other than gold, silver and monetary units, durable assets and shares representing pools of assets can be exchanged with money at market-based pricing with at least one item of the exchange delivered on the spot. Gold, silver or any monetary units (Athman) are subject to the rules of Bai‘ alSarf, i.e. equal for equal and hand to hand in the case of homogeneous currency, and hand to hand in the case of different units of currency being exchanged. Usufruct and services (leasing/services) can be exchanged with rentals/wages to be paid in advance, on the spot or deferred. Loans/debts have to be paid without premium and discount and cannot be sold, except by recourse to the original debtor and at face value.

The famous Hadith of the holy Prophet (PBUH) regarding the exchange of six commodities, i.e. gold, silver, wheat, barley, dates and salt, has laid the foundation of these rules. These commodities belong to two categories: two, gold and silver, can serve as monetary units while the remaining four are edible goods. On this basis, jurists have identified two causes (‘Illah) of prohibition and held detailed discussions on the rules in respect of application to other goods, reaching consensus on a number of aspects.

The OIC Fiqh Council in its eleventh session (14–19th November, 1998) resolved: “It is not permissible in Shari’a to sell currencies by deferred sale, and it is not permissible, still, to fix a date for exchanging them. This is evidenced in the Qur’¯an, Sunnah and Ijm¯a’.”
The Council observed that contemporary money transactions are major factors behind the financial crises and instability in the world and recommended: “It is incumbent upon Muslim governments to exercise control over money markets and to regulate their activities relating to transactions in currencies and other money-related transactions, in accordance with the principles of Islamic Shar¯ı´ah, because these principles are the safety valve against economic disaster”.

Time Value of Money in Islamic Finance

There is almost a consensus among Shari’a scholars that the credit price of a commodity can genuinely be more than its cash price, provided one price is settled before separation of the parties. According to many jurists, the difference between the two prices is approved by the Nass (clear text of the Shari’a). The Islamic Fiqh Academy of the OIC and Shari’a boards of all Islamic banks approve the legality of this difference. This is tantamount to the acceptance of time value of money in the pricing of goods. What is prohibited is any addition to the price once agreed because of any delay in its payment. This is because the commodity, once sold (on credit), generates debt and belongs to the purchaser on a permanent basis and the seller has no right to re-price a commodity that he has sold and which does not belong to him.

Jurists allow the difference between cash and credit prices of a commodity, considering it a genuine market practice. Both time and place have their impact on the price. A commodity sold for 100 dollars in a posh area might be available for 50 dollars in a middle class residential area. Similarly, an object with a price of 100 dollars in the morning might be available for 50 in the evening. This is all acceptable in Shari’a if caused by genuine market forces. Similarly, it is quite natural that the credit price of a commodity is more than its cash price at a point in time, while in forward contracts like Salam; the future delivery price is less than the spot price. The concept of time value of money in the context of Shari’a is also established from the fact that Shari'a prohibits mutual exchanges of gold, silver or monetary values except when it is done simultaneously. This is because a person can take benefit from use of a currency which he has received while he has not given its counter value from which the other party could take benefit.

The contract of Salam also provides ample illustration of the concept of time value of money through pricing of goods. Salam is a forward contract which enables a commodity to be bought for immediate payment of the price and future delivery. The basic element of this contract is that the price paid in advance for future delivery of the goods is genuinely less than the cash-n-carry price at the time the Salam contract is executed.

It further transpires from the shari'a tenets that time valuation is possible only in business and trade of goods and not in the exchange of monetary values and loans or debts. Islamic economics has the genuine provision of converting money into assets on the basis of which one can measure its utility, but loaning is considered a virtuous act from which one cannot take any benefit.

As such, "mark-up" in trade is permissible provided the Shari'a rules relating to trade are adhered to, but interest is prohibited due to being an increase over any loan or debt. Therefore, no time value can be added to the principal of a loan or a debt after it is created or the liability of the purchaser stipulated. Time is invaluable; once wasted, it cannot be refurbished. So it should not be compared with money, which, if stolen or snatched, can be restored. In business, however, one keeps in mind the time factor as a natural phenomenon to strike a fair balance between the forces of demand and supply.

Money, Monetary Policy and Islamic Finance

Money is the most strategic factor in the functioning of any financial system. The status, value, role and functions of money in Islamic finance are different from those in conventional finance. In the conventional system, money is considered a commodity that can be sold/bought and rented against profit or rent that one party has to pay, irrespective of the use or role of the lent money in the hands of the borrower. As this is not the case in Islamic finance, the philosophy, principles and operation of Islamic finance differ to a large extent from the principles and operation of conventional finance.

Experts in Islamic economics concede the advantages of money as a medium of exchange. The holy Prophet (PBUH) himself favoured the use of money in place of exchanging goods with goods. The prohibition of Riba Al-Fadl in Islam is a step towards the transition to a money economy and is also a measure directed at making barter transactions rational and free from the elements of injustice and exploitation.

Status of Paper Money

The present form of money has evolved over time from various types of goods used as money and metallic money to paper and electronic money. Money in the present form, or the currency notes in vogue, are a kind of Thaman (a unit of account to serve as the price of anything), just like gold and silver used to be in the past. In this form it is wanted only for exchange and payments and not for itself, as it has no intrinsic value. Accordingly, the present fiat or fiduciary money represents monetary value for all purposes of making payments; the currencies of all countries are unlimited legal tender and creditors are obliged to accept them for recovery of debt.

Linking money to productive purposes brings into action labour and other resources bestowed by Allah (SWT) to initiate a process from which goods and services are produced and benefits passed on to society. Therefore, paper money is subject to all the tenets of Shari'a relating to Riba, debts, Zakat, etc. One cannot sell a 10 dollar bill for 11 dollars because the bill represents pure money and has no intrinsic value. Notes of any particular currency can be exchanged equal for equal. Currency notes of different countries are considered monetary units of different species and therefore can be exchanged without the condition of equality but subject to the conditions of Bai' alSarf (currency exchange), i.e. hand to hand.

Trading in Currencies

Paper currencies cannot be sold or bought like goods having intrinsic value. The Shari'ahas treated money differently from commodities, especially on two scores: first, money (of the same denomination) is not held to be the subject matter of trade, like other commodities.

Its use has been restricted to its basic purpose, i.e. to act as a medium of exchange and a measure of value. Second, if for exceptional reasons, money has to be exchanged for money or it is borrowed, the payment on both sides must be equal, so that it is not used for the purpose it is not meant for, i.e. trade in money itself. In the context of trading in goods, as distinct from exchange of various currencies, Shaikh M. TaqiUsmani in SAB Judgement says: "The commodities can be of different qualities. Therefore, transactions of sale and purchase are effected on an identified particular commodity. Money has no quality except that it is a measure of value or a medium of exchange. All units of money of the same denomination are one hundred per cent equal to each other. If A has purchased a commodity from B for Rs.1000/= he can pay any Note(s) of Rupee amounting to Rs.1000 _ _ _ ".

Creation of Money from the Islamic Perspective

The monetary and credit policies in any economy have a great impact on the functioning of its financial system through their impact on the quantity and value of money. As against bullion money, paper or fiduciary money can be created simply by ledger entries or the issuing of paper securities and without regard to a corresponding increase in goods and services in an economy. This leads to distortions and exploitation of a segment in society by others. In the Islamic financial system, where exploitation of one by another is strictly prohibited, the supply or growth of money/credit should match the supply of goods and services. There might be some minor mismatches, but persistent mismatches are not consistent with the principle of Islamic finance, as they generate distortions in the payments system and injustice to any of the parties to the contracts.

Of all the features of Islamic financial instruments, one stands out distinctly – that these instruments must be real asset-based. This means that Islamic banks are not able to create money out of nothing or without the backing of real assets, as is the case in the conventional system today.

Currency Rate Fluctuation and Settlement of Debts

IFIs create debts/receivables by way of trade and leasing-based modes. What impact inflation has on their receivables is an area of important discussion. Before deliberating upon the shari'a position of linking the debts with any money or a commodity, it is pertinent to observe that, even in conventional finance, indexation is not normally used to make up the loss occurring due to inflation. Conventional institutions rather make a provision for a floating rate in the agreements, keeping in mind the future inflationary pressures. As such, any new rate is applied on the remaining period, while it does not affect the liability already accrued.

Islamic banks are not allowed as a rule to link any debt or receivable for the purpose of indexation. In certain modes/products, however, they are allowed to stipulate a floating or variable rate. But this does not affect any debt liability already created. For example, in Ijarah, Islamic banks can charge rental at a higher rate, if already provided for in the agreement, for any remaining period of the lease; but the rentals for a particular period once accrued cannot be indexed.

The clear injunctions of the Holy Qur'¯an and Sunnah reveal that if the financial contribution takes the form of a loan or a debt, it is to be paid back exactly in the same kind and quantity, irrespective of any change in the value of the concerned currency or price of the commodity lent or borrowed, at the time of return of the loan. This principle is applicable not only for loans and debts but also for credit, barter, deferred exchange of currency, delayed payment of remuneration after devaluation or revaluation, indemnity and a change in the unit of currency at the time of redemption of the loan.

However, if the currency of the debt becomes extinct or is not available for any reason, its counter value will be paid to repay the debt and the rate will be that of the due date. For example, a credit sale executed on 1st July generates a debt of ten Saudi Riyals (SR) payable on 31st December. On the due date, i.e. 31st December, the purchaser is liable to pay SR 10 irrespective of the Riyal's value in terms of any other currency. If the debtor is obliged to pay in Rupees for any reason, the exchange rate will be that which is prevailing on 31st December because he was liable to pay Saudi Riyals on that date.