

TOWARD AN ISLAMIC BANKING THEORY

by

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INTRODUCTION

Every economic system tries to solve the economic problems confronting it according to its own philosophy. That is, each society tries to choose the economic system which is consistent with its ideology. Both capitalist and socialist countries have devised certain rules of conduct that, by and large, are consistent with their values. But if we look at the Islamic world it is not hard to discover that a gap exists between the prevailing institutional framework and the Islamic principles. Several factors have contributed to this schizophrenic situation. Some of these factors are exogenous while others are indigenous.

During the waning days of the Ottoman empire, the Islamic world had gone through a period of stagnation; both economically and intellectually. This was followed by a period where most of the Muslim countries were subjected to foreign domination. This colonization has accentuated the separation of secular from religious education. It also led to the introduction and adoption of an institutional framework which was alien to the Islamic culture. The colonial institutions have lasted long after the colonial powers have left. To make things worse, the colonial educational system, both at home and abroad, has perpetuated the problem instead of helping resolve it. As a result the link between the present institutions and the Islamic teachings was weakened if not severed. An awkward situation prevailed because of this duality. Several attempts have been made to remedy this situation.

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One of the areas in which the inconsistency persists is the financial system. Could the banking system, for instance, be reconciled with the Islamic principles? And, if so, how could it be done? This paper is an attempt toward reconstructing the banking system on Islamic basis. In the first part some basic concepts will be introduced. Then in the second part the current theoretical framework will be examined. In the third and final section a general formulation of an alternative Islamic banking system will be presented.

1. Some Basic Concepts

The banking system, as it is practiced today, contradicts to a large extent Islamic values. Most of the banking charges are considered "Riba" (usury). This raises the issue of how to reconcile this conflict and how to devise a "Riba" - free banking system which is consistent with Islamic ideals. But we have to digress for amoment to define both the commercial bank and the "Riba".

A. Banks :

Commercial banks are financial intermediaries which engage, among other things, in obtaining funds from ultimate lenders and channel them to ultimate borrowers. There are, however, some characteristics which distinguish commercial banks from other financial institutions. ¹ First, Commercial banks carry demand deposits which are generally accepted as means of payment. Second, given the institutional set up, commercial banks are concerned with their Liquidity position and hence engage in short term credit transactions. We turn now to the definition of "Riba".

B. Riba:

"Riba" is the excess amount to be paid over and above the amount exchanged and borrowed. Paying and receiving "Riba"

¹ Other bank and non-bank financial institutions include specialized banks, saving and loan associations, insurance companies and pension funds.

is strictly prohibited in Islam. This was clearly stated in both the Quran and the Hadith.

Those who devour usury will not stand except as stands one whom the evil one by his touch hath driven to madness. That is because they say : 'Trade is like usury', but God hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for God (to judge) ; but those who repeat (the offense) are companions of the fire: they will abide therein (forever) . God will deprive usury of all blessing, but will give increase for deeds of charity; for He loveth not creatures ungrateful and wicked. Those who believe, and do deeds of righteousness, and establish regular prayers and regular charity, will no fear, nor shall they grieve. Ye who believe ! Fear God, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, take notice of war from God and His Apostle : but if ye turn back, ye shall have your capital sums : deal not unjustly, and he shall not be dealt with unjustly. 2

We can proceed now to discuss briefly a theory which describes the behaviour of a banking firm as it is perceived today.

II. The Present Banking Theory

Like other firms a bank is assumed to allocate its resources in such a way so as to maximize its returns on equity. In this respect the bank is constrained by its balance sheet accounts. In a simplified general form, 3 the bank's liabilities are assumed to consist of equity (W) and deposits (D;). The bank deposit liabilities are postulated to be a proportion (α_i) of total funds

2 Albagara, 275-279.

3 In this section, I am following closely Michael A. Klein's model in "A Theory for the Banking Firm", The Journal of Money, Credit and Banking (May, 1971), 205-218.

(F).

$$W = F (1 - \sum \alpha_i) \quad (1)$$

There are pecuniary and non-pecuniary costs to these deposits. The cost of issuing demand deposits (D_1) and time deposits (D_2) are assumed to be as follows :

$$D_1 = D_1 (R_1) \quad D_1' > 0 \quad (2)$$

$$D_2 = D_2 (R_2) \quad D_2' > 0 \quad (3)$$

Where R_i is the return on deposits.

On the other hand, bank assets (X_j) include cash (X_1), private loans (X_2) and government loans (X_3). The returns on loans are assumed to be a function of interest rates.

$$E_L = h (X_2) \quad h < 0 \quad (4)$$

Although cash has no explicit rate of return, it nevertheless reduces the penalty for bank deficiency. The expected returns on cash are defined to be

$$n \left[\frac{(X - c)^2}{2(c - b)} \right] \quad (5)$$

Where n is the penalty cost for deficiency, c is the largest disbursement and b the lowest deposit loss. The problem then is to maximize the rate of return on equity (E), subject to the balance sheet constraint, i.e. maximize

$$E_w = \left[\frac{1 + D_1(R_1) + D_2(R_2)}{W} \right] \left[X_1 h (X_2) + X_3 E_g - \frac{n (X - c)^2}{2(c - b)} \right] \quad (6)$$

subject to $\sum X_j = 1$ (7)

The previous formulation indicates that the price banks offer for deposits depends upon the profitability of bank lending and other factors affecting the inflow of deposits. Bank environment as well as market structure affect banking performance.

The theory presents a set of assumptions concerning bank behaviour which are plausible and verifiable in the present circumstances. But this theory which revolves around the interest

rate, cannot explain how a banking firm could operate in an Islamic environment. The next section gives some direction toward this alternative.

III. Banking Operations In An Islamic Context

The banking practice is looked upon from somewhat different perspective in Islam. No interest should be paid either on loans or deposits. How then could deposits be attracted to the banking system? And how could banks be adequately compensated for providing loans and other services? No adequate answer can be provided without redefining the banking operations in an Islamic context.

According to the Islamic principles interest on loans and deposits are considered "Riba" and Muslims are prohibited from paying or receiving such interest. This stems from the Islamic principle that things should not be exchanged for more than their worth, whether in measurement, weight or value. Even capital, if loaned should be returned intact. The profit or loss should accrue to the person using the capital unless agreed otherwise.

" . . . but if ye turn back, ye shall have your capital sums: dealt not unjustly, and ye shall not be dealt with unjustly". 4

On the other hand, if the operation is a joint venture; one contributing capital and the other his effort and skill, then they should share the outcome whether it be a profit or loss. However, a necessary prerequisite is the uncertainty of the outcome of the venture.

Another rule is that if somebody is hired to do a certain job or service he should be compensated accordingly.

If we combine the previous rules (joint venture and service compensation) together with the bank's role as a financial in-

4 Op. Cit, 279.

termediary a "Riba" - free banking system becomes attainable.⁵ The bank would obtain some specified amount as service charges in return for managing deposits and providing other banking services, for that is permissible under Islamic principles. The depositors can, if they wish, use their funds as part of a mutual partnership between the bank and its clients. Hence instead of receiving interest on deposits they will share in profits. The bank, on the other hand, can be as a full partner to both depositors and borrowers. The depositors would share in profits according to the size and duration of their deposits. The bank would, in turn, share profits with borrowers according to an agreed amount or percentage. Thus the conflict between Islamic and non-Islamic practice can be resolved.

This is the general conceptual framework of an Islamic banking firm. A rigorous treatment of this framework (in the form of amathematical model) will have to be dealt with in a separate paper.

CONCLUSION

Since the banking system, as it is practiced, is an institution alien to Islamic culture it should be adjusted to conform to Islamic principles and not the other way around. Using Islamic concepts in compensation, exchange and partnership would reconcile the difference between what is practiced and what an Islamic banking system should be.

⁵ For a detailed treatment of the issues discussed in this section, the reader is referred to the work of Dr. Sami H. Hammoud, *Tatweer Al-A'maal Almasrafia Bima Yattafiqu Wa Al-Shariah Al-Islamia* (Cairo, Egypt : Dar Al-Turath 1976). (in Arabic)