

Fiqh or Fiction

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Is Islamic Banking Truly Islamic, or is it just cosmetically enhanced conventional banking?

Islamic bankers, caught between scholars and layman, devote much of their time to an often-skeptical public about the authenticity of their products. Time well spent. The purgative effects of ridding the Islamic financial sector of pretenders (and there are many) at the hand of an educated consumer are obvious. Too often, however, this educational process is long on theory and short and practical relevance.

Perhaps the easiest way to determine whether Islamic banking is true to Quran, Sunna and customer is to see how it actually works in practice. The Islamic banking discussed here is the same one that earns consensual acceptance from the field's leading scholars of the traditional schools of jurisprudence. And while unscrupulous banks do exist, increasing market regulation and customer sophistication ensures that those Islamic banks that are truly Shariah-compliant lead the industry. By learning the basics about these banks, individuals will be better able to stand their ground when not-so-Islamic bankers push non-complaint instruments in the name of Islam.

At the outset, though, it is necessary to emphasize two important points. First, just because an Islamic product and a conventional product are identical does not render the Islamic product impermissible. As obvious as this seems, it is an argument detractors often use to discredit Islamic banking. The vast majority of Islamic financial instruments bear a strong resemblance to their conventional counterparts, particularly equity – based ones (see “In Your Interest”, Islamica, Winter2003). What distinguishes them from conventional instruments is usually nothing more than a set of processes, which leads to the second point.

In Islam, the difference between whether something is forbidden, offensive, permissible, recommended or obligatory usually depends on a validating process. Two couples, one married the other unmarried, may look the same, but the agreement of simple marriage contract makes the one Islamically valid and the other not. Two hamburgers, one using Islamically slaughtered meat and the other not, may look the same, but a simple process makes one valid. So too, two financial products, one Islamic the other not, is differentiable by a set of steps: ostensibly cosmetic, Islamically defensible.

The following are among the most commonly asked questions by customers new to Islamic banking (ordered in increasing degree of complexity).

There was no Islamic bank during the Prophet's (Allah bless him and give him peace) time, so how can there be Islamic banking now? Sounds like a bida (innovation).

Microchips, potato chips and Islamic banks are examples of permissible things for which the Prophet (Allah bless him and give him peace) gave us no specific guidance. Rather, he forbade us from engaging in blameworthy innovations (bida) that would contravene the Islamic Sacred Law (Shariah), rather than from new things that possess no intrinsic blameworthiness. The bida is in the blameworthiness, not in the newness.

Admittedly, some Islamic banks do not carry out impermissible transactions, but that implicates the entire field of Islamic banking no more than the sins of a few Muslims incriminate the entire Islamic community.

As for the claim that Islamic banking is just part of the “system” and is therefore best avoided, is to put one’s head firmly into sand; romantic anachronists need not apply. As long as Muslims, money and capital markets coexist, there will always be a need for Muslims to put their money into some kind of a market (even a little money in a checking account circulates into global capital markets). The question Muslims should really be asking themselves is: their money in the most Islamically acceptable manner available to them given the options. And while new customers might be forgiven some level of healthy skepticism, we should all understand the limits of our own unqualified ijtihads when declaring something a bida.

Don’t Islamic banks simply change labels, by replacing the word “interest” with “profit”?

Some Islamic banks do just that. And here is the easiest way to find out the truth: ask them if the profit amount (not the percentage amount) is fixed, or if the customer profit is declared before the bank’s actual profit is announced. If either of these is the case, their “profit” is just another kind of riba (usury or interest).

Interest, the additional charge over the loan principal, is the “cost” of using money, and is strictly forbidden in Islam, whether given or taken, at a low rate or a high one, to or from a Muslim or a non-Muslim, whether in Muslim lands or not. The problem with exchanging one amount for a larger amount of money at a later date is that there is no underlying asset or service transacted.

Profit, rent and mark-up, on the other hand, are asset and service backed, and permissible in Islam. Profit is earned on the sale of goods and the provision of services. Rent is charged on the usufruct of property. Mark-ups are added to the cost of an asset. The most common financing products that an Islamic bank will use in order to earn profit are musharakas (partnership financing) and mudharabas (investment finance).

In a Musharaka, two or more partners (even thousands of shareholders) commit risk capital and share profit based on an agreed upon percentage, enduring loss in proportion to their invested capital. Modern corporations, like those listed on the New York Stock Exchange, are a kind of Musharaka.

In a mudharabas, an investing partner brings capital and a working partner brings time and effort to share in profits and losses agreed upon beforehand. Venture

capital firms, such as the ones that financed much of Silicon Valley's growth, are a kind of mudharabas.

Unlike with interest, which is charged on a borrower whether the business succeeds or fails, in a Musharaka and Mudharaba the investor profits only when the business profits and therefore the investor fully shares in the business risk. Some might argue that an interest based lender also shares risk: the risk of whether his money will be returned or not. But this is not a 'Business risk'; it is a 'Credit risk'. The difference is a substantial, a business risk only risks the business; a credit risk both business and the borrower (by forcing repayment, in extreme cases through personal bankruptcy).

Why does Islam forbid interest when money is just another commodity that comes at a price?

Unlike an actual commodity (like gold, which has traditionally been the standard of measure for currencies), money has no intrinsic value. It derives its value from something other than itself, namely, market demand. So interest actually creates nothing. By creating money from nothing, we bloat economies with asset-less, service-less pieces of paper. And we all know what happens when the supply of anything, even money, exceeds its demand. Its price drops. And when the "price" of money drops, we get inflation; the money in our pocket becomes worth less today than it was yesterday. However simplified and stylized this description, it accurately illustrates the macroeconomic debilitation of interest. Because interest serves the interest (coincidence?) of capital owners like banks, governments, "development" agencies, corporations and wealthy individuals, it is unlikely to go away.

The treatment of money as a commodity is partly responsible for burgeoning world poverty. (By forcing poor countries to allocate increasing amount of capital away from social services, like health care and education, towards debt servicing) and increased market volatility (by widening the gap between the supply of money and the creation of real assets). It is often asked how we would live in a world without interest. We might instead begin asking how should we be expected in a world with interest?

Where should I keep my money? Islamic banking doesn't adequately address the inflation problem and then you say interest banking is forbidden. If today's \$1 is going to be worth 90 cents next year because of inflation, why cant I charge interest to compensate for the loss?

The short answer: because interest is still wrong. Charging interest to compensate for interest is analogous to terrorizing civilians to compensate for global injustice: to wrong do not make a right. Far too many Muslims, sincere practicing ones no less, have somehow reconciled the taking of interest with their personal definition of what the Quran and Sunnah say about the matter. But compensating for inflation is still no excuse for taking interest; no matter how noble one might feel when taking money from conventional bank. In order to compensate for inflation, Islamic banks provide plenty of instruments that mimic the security and liquidity of an ordinary savings account while also providing a reasonable interest-free return (Meezan Bank's monthly Musharaka certificate is just one

example, but all major banks, including non-Muslim banks that sell permissible Islamic products, offer basic consumer accounts).

If making a long-term personal loan, for instance, one might consider denominating the amount in gold (e.g. an individual lends \$100 cash today and tells a borrower that he would like gold equivalent amount back in 3 years; \$100 buys X grams of gold today; at the time of repayment 3 years later, X grams of gold buys \$120; the borrower returns the lender the lender \$120 cash).

Stocks are like gambling, but Islam permits stocks and forbids gambling. Why?

This returns to the basic principle of asset and service backing. Stocks invest in real assets (a company's property, plant and equipment) and actual services (a company's management expertise). Gambling invests in nothing. Even if a lottery funds charities or finances public works, the money with which it does so is still haram. Stocks provide risk-based returns based on publicly available information. Gambling provides only uncertainty and the distance prospect of huge gains based entirely on chance.

To the casual observer "buying low and selling high" resembles gambling, but because there is no Islamic stipulation on the price at which something is sold and the duration of which it is held, the primary concern relates to what is actually bought and sold. Provided the main business of the company is permissible, the company owns some illiquid assets, and the investor removes the proportion of his profits that correspond to the company's interest earnings. Then purchasing the stock is permissible.

What's the difference between an ordinary lease and an Islamic lease (Ijarah)? They look the same.

An Ijarah lease, like a conventional lease, is an agreement to rent out property and services. In an Ijarah lease the lessor (the person granting the lease) maintains ownership of the property or service while the lessee (the person to whom the lease is granted) gains use of the property and the resulting profit. In conventional financial leasing, the interest payments have to be made to the lessor whether the lessee gains the benefit from the property or not. If the property is damaged through no fault of the lessee's, the interest payment is still payable. So the ownership risk does not entirely rest in the owner's hands. Ijarahs, on the other hand, clearly distinguish between ownership and usufruct, or the use and profit of a thing, and stipulate the rental rates, unlike the interest rate, be known and agreed upon beforehand.

The central component of a valid Ijarah agreement is the appropriation of risk, specifically the ownership of risk. In an Islamic lease, risk associated with the lease property or service remains with the lessor, the beneficiary of the rental payments.

If Islam forbids fixed-income interest, what's wrong with floating-rate interest? Doesn't it allow raise and fall like profit?

Islam does not forbid fixation. It is permissible to fix profits (in percentage,

not absolute, terms), prices, rents and installment plans, to name a few measures. But it is forbidden to exchange money for a larger amount of money (unless the currency is different, in which case it is permissible at spot). The unlike exchange of like moneys creates *riba*. But exchanging assets or services for money and money for assets and services is entirely permissible. So the problem does not relate to whether an interest rate is fixed or floating, but to the interest itself.

I don't have enough money to buy factory equipment (a car, or a home or pay for an education). How do I avoid interest and still fulfill my short-term financing requirements?

Murabaha (mark-up financing) is an example of an Islamic instrument that funds short-term capital requirements. Because it is the most easily confused with interest-based financing, it is worthwhile going through the basic steps in a Murabaha execution:

A customer approaches an Islamic bank with a request to purchase an item, promising to pay at some later date. The bank assesses the product and the customer's collateral (collateral is an Islamically acceptable method of securing a financial obligation) and agrees by making the customer his agent. The customer goes to the market and selects the product. The bank pays the vendor, charges the customer a mark-up, and the customer takes the product agreeing to pay him later.

This is analogous to a friend buying something on your behalf, charging a little extra for the time and effort, and selling it to you with an expectation that you will repay him at some later date. This is instead of giving you cash to buy it now, and asking for the cash at some later date, charging you interest in addition to the loan amount.

In a Murabaha, the bank provides financial intermediation entirely free of interest, and because the bank buys and sells an asset, even if at a profit, the transaction is Islamically permissible. The difficulty people have in differentiating a Murabaha from a simple short-term loan is by not appreciating the importance of the seemingly insignificant intermediate step of the bank owning the item by paying the vendor directly. What this does is satisfy the very basic Islamic requirement of backing the transaction with an asset. The mark-up is no different from the profit any business makes for having a legitimate service. For home purchases, diminishing partnership schemes (or "diminishing *musharakas*") also provide the buyer with a financing alternative. In a diminishing partnership agreement the buyer approaches the bank with a down payment. The bank pays for the rest of the property and the buyer begins living in the property while paying the bank rent. Over time, the buyer buys back the bank's equity in the house and reduces his monthly rent in proportion to his increased ownership of the house.

Eventually, the buyer becomes the sole owner. The important point is that the Islamic bank participates the customer's ownership risk.

Is there a secondary market for Islamic instruments?

A secondary market is a fancy name for any exchange with securities (like stocks)

are bought and sold after their original issuance. Islamic leases, or Ijarahs, are an example of a securitisable instrument.

Because lessors have the right to sell all or part of their leases to one or more third parties without affecting the continuity of the lease itself, Ijarah certificates may be traded like securities under certain conditions. An Ijarah certificate represents the third parties new ownership in the lease as well as the proportionate share in claiming rent and suffering loss. Ownership, not the right to claim rent, represents the tradable portion to the certificate. Islam permits the trading the assets, not of money, for profit, and a rental claim is a receivable that represents money. SO trading rental claims without first transferring ownership is forbidden. But it is acceptable for buyers seeking ownership and sellers seeking profit to trade Ijarah certificates like common securities in a capital markets.

Islamic banks face an unusual set of competing demands today. On the one hand, the Islamic banking sector is growing at about four times the rate of the industry as a whole. But on the other hand, Islamic banks are forced to conform to a regulatory environment that has traditionally catered to a well-entrenched interest banking system. As a result, Islamic banks now inherit a customer base so accustomed to dealing in interest that to suggest an alternative, particularly one with a well-laden “Islamic” label attached, is to imagine the seemingly unimaginable. But in just the few decades of consumer-label Islamic-banking, a centuries-old conventional finance sector is beginning to acknowledge the importance of providing an Islamic alternative, evidenced most tellingly by the creation of Islamic subsidiaries within banks, whether Islamic or not, are profit-motivated and demand-driven, it is important that the Islamic banking customer demands products that are compliant, for which the first step is self-education about what actually makes a financial product Islamic.

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