Can Banks Survive without Interest?

By (Muhammad Ayub)*

Before discussing the hypothesis that banks can survive without the institution of interest it is pertinent to mention that the Shariah does not prohibit all gains on capital. It is only the increase stipulated or sought over the principal of a loan or debt that is prohibited. Islamic principles simply require that performance of capital should also be considered while rewarding the capital. The prohibition of a risk free return and permission of trading, as enshrined in the Verse 2:275 of the Holy Quran, makes the financial activities in an Islamic set-up real asset-backed with ability to cause 'value addition'. The forms of businesses allowed by Islam at the time the Holy Quran was revealed included joint ventures based on sharing of risks & profits and provision of services through trading, both cash and credit, and leasing activities. Allah the Almighty did not deny the apparent similarity between trade profit in credit sale and Riba in loaning, but resolutely informed that Allah has permitted trade and prohibited Riba.

Besides trading, Islam allows leasing of assets and thus taking rentals against the usufruct taken by the lessee. The contracts of loans are different from the lease contracts on the basis that ownership in leased assets remains with the lessor who assumes risks and gets rewards of his ownership. In loans, on the other hand, ownership of loaned goods/assets is also transferred to the loanee/borrower who is obliged to repay its similar. All such things/assets corpus of which is not consumed with their use can be leased out against fixed rentals, while money cannot be leased out.

Profit has been recognized as 'reward' for (use of) capital and Islam permits gainful deployment of surplus resources for enhancement of their value. However, alongwith the entitlement of profit, the liability of risk of loss rests with the capital itself. No other factor can be made to bear the burden of the risk of loss. Financial transactions, in order to be permissible, should be associated with tangible real assets. At macro level, this feature of Islamic finance can be helpful in creating better discipline in conduct of fiscal and monetary policies.

Savers who have been avoiding the banking channel so far due to involvement of Riba would approach Islamic Banks only when they are assured that their funds would be invested in Shariah compliant activities. Therefore, credibility of Islamic banks is crucial and the key to success and development of this emerging discipline. Users of bank funds take the benefit of having access to the savings of millions of middle class depositors and as such they should give to the savers the due share in profit that they earn from the business activities. The most important pre-requisite in this regard is mass awareness about the concept of Islamic banking among the general public and the education of bankers and the business community.

Islamic banks, while functioning on a basis other than interest, have to perform a crucial task of resource mobilization, their efficient allocation on the basis of both PLS (Musharaka and Mudaraba) and non-PLS (trading & leasing) based categories of modes and strengthening the payments systems to contribute significantly to economic growth and development. Sharing modes can be used for short, medium and long-term project financing, import financing, pre-shipment export financing, working capital financing and financing of all single transactions. In order to ensure maximum role of Islamic finance in development of the economy it would be necessary to create an environment that could induce financiers to earmark more funds for Musharakah/Mudarabah based financing of productive units, particularly of small enterprises.

The non-PLS techniques, as acceptable in the Islamic Shariah, not only complement the PLS modes, but also provide flexibility of choice to meet the needs of different sectors and economic agents in the society. Trade-based techniques like *Murabaha* with lesser risk and better liquidity options have several advantages vis-à-vis other techniques but may not be as fruitful in reducing income inequalities and generation of capital goods as participatory techniques. Ijarah related financing that would require Islamic banks to purchase and maintain the assets and afterwards dispose of them according to Shariah rules, require the banks to engage in activities beyond financial intermediation and can be very much conducive to the formation of fixed assets and medium and long-term investments.

On the basis of the above it can be said that supply and demand of capital would continue in an interest-free scenario with additional benefit of greater supply of risk-based capital alongwith more efficient allocation of resources and active role of banks and financial institutions as required in asset based Islamic theory of finance. Islamic banks can not only survive without interest but also could be helpful in achieving the objective of development with distributive justice by increasing the supply of risk capital in the economy, facilitating capital formation, and growth of fixed assets and real sector business activities.

Salam has a vast potential in financing the productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole. It also provides incentive to enhance production as the seller would spare no effort in producing, at least the quantity needed for settlement of the loan taken by him as advance price of the goods. Salam can also lead to creating a stable commodities market especially the seasonal commodities and therefore to stability of their prices. It would enable savers to direct their savings to investment outlets without waiting, for instance, until the harvesting time of agricultural products or the time when they actually need industrial goods and without being forced to spend their savings on consumption.

Banks might engage in fund and portfolio management through a number of asset management and leasing & trading companies. Such companies/entities can exist in the economy on their own or can be an integral part of some big companies or subsidiaries, as in the case of Universal Banking in Europe. They would manage Investors Schemes to mobilize resources on Mudarabah basis and to some extent on agency basis, and use the funds so collected on Murabaha, leasing or equity participation basis. Subsidiaries can be created for specific sectors/operations, which would enter into genuine trade and leasing transactions. Low-risk Funds based on short-term Murabaha and leasing operations of the banks in both local as well as foreign currencies would be best suited for risk-averse savers who cannot afford possible losses, in PLS based investments. Under equity based Funds, banks can offer a type of equity exposure through specified investment accounts where they may identify possible investment opportunities from existing or new business clients and invite account-holder to subscribe. Instead of sharing in the bank's profit, the investors would share the profits of the enterprise in which funds are placed with the bank taking a management fee for its work. Banks can also offer open-ended Multiple Equity Funds to be invested in stocks.

Small and medium enterprises (SME) sector has a great potential for expanding production capacity and self-employment opportunities in the country. Enhancing the role of financial sector in development of SME sub-sector could mitigate the serious problems of unemployment and low level of exports. The banks may introduce 'SME Financing Funds' with various geographical locations. The corporate sector and the commercial banks may set up a network of such Funds under the aegis of SECP by establishing institutions under syndicate arrangements or otherwise.

Islamic banking and finance is a part of Islamic economic system, the very basis of which revolves around justice and morality. Moral dimension, therefore, is *raison d'etre* of Islamic banking and finance. Progress on development of instruments for liquidity management, SLR and OMOs is overdue. Serious efforts are needed in this context on the pattern of Sudan and Bahrain (in respect of Musharaka, Ijarah and Salam Sukuk, and Malaysia (in case of Mudarabah based Islamic money market). Documentation of the economy, replacing income tax of the corporate sector with expenditure tax and amendment in other relevant laws are essential requirements. Only a well thought out plan with committed and sustained efforts could lead to success and ultimately to transformation of the economy.

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