

Profit-Sharing: Questions That Need to be Answered

Whether the Shariah allows the practice of using interest rates to calculate profit-sharing ratios requires serious discussion. *Sudin Haron* looks at the relationship between conventional banking and the profit-sharing schemes of Islamic Banks.

Today, there are more than 150 interest-free financial institutions operating world-wide. These institutions not only serve the banking needs of Muslims, but some Islamic banks are also happy to accommodate the needs of non-Muslims. Some of the existing financial institutions are either subsidiaries or one of the departments of conventional banks. To what extent this will help the future development of the Islamic banking system and how the Ummah will gain from this development are interesting questions that need to be answered.

One thing that concerns those who have direct or indirect interest in the Islamic banking system is the relationship between market interest rates and the profit-sharing and mark-up ratios of Islamic banks. Some scholars have acknowledged that, in no way, could Islamic banks ignore the element of interest in their operations.

Sami Hassan Homoud, for example, in his article which appeared in the December 1994 issue of *Islamic Economic Studies*, claimed that there is no known way of avoiding the link up between interest rate and the profit margin in Murabaha, as long as Islamic banks are operating within an environment where they co-exist with traditional banks. This intimate relationship with interest rates affects not only the ratios of financing activities but also the rates of return to depositors.

Anne Simpson and Paul Willing in their article published in the December 95/January 96 issue of *New Horizon* suggested the possibility of Islamic banks practising a 'smoothing' policy. This term refers to the policy where the management of Islamic banks tries to smooth the reported profits, through the operation of provisions and reserve accounts in order to give a market rate of return to depositors.

The linkage between the interest

rate and profit-sharing and mark-up ratios, however, remains a contentious issue. Volker Nienhaus, for example, in his article published by the Journal of Research in Islamic Economics in 1983, made a blunt suggestion that the calculation of profit-sharing ratios by Islamic banks must be based on the market rate of interest. This suggestion, however, was rejected by M N Siddiqui, Ziauddin Ahmad and M Fahim Khan - all eminent scholars in the field of Islamic banking.

Nevertheless, it is not reasonable to assert that there is no connection between market rates or interest and the ratios of mark-up activities (bai Murabaha, bai Muazal or bai bithaman ajil, Ijara and Ijara wa-iktina) when the instalment paid to an Islamic bank is equivalent to conventional bank instalments of loans on the same terms and conditions. Similarly, only the most naive individual could believe that the similarity between the market rates of interest and profit-sharing and mark-up ratios is purely an incidental phenomenon.

The fundamental question here is: is it wrong for Islamic banks to use interest rates as a benchmark in fixing their profit-sharing and mark-up ratios or percentages?

Although this question looks simple enough, nobody has yet supplied a concrete answer. To the best of my knowledge, there is no literature which indicates that the practice of using interest rates as a basis of calculating ratios at Islamic banks is prohibited by Shariah. Similarly, none of the Shariah Supervisory Boards (SSBs) of Islamic banks has issued a fatwa related to this matter.

All the reports issued by the SSBs of about 20 Islamic banks confirmed that the operations of the Islamic banks under review were conducted in accordance to Shariah. Since SSBs are responsible for scrutinising the operations of Islamic banks and if it is true

that Islamic banks are using interest rates as a benchmark, it is therefore reasonable for us to conclude that this practice is allowed by Shariah.

The question whether Shariah allows the practice of using interest rates as a benchmark requires serious discussion. The Shariah scholars need to include this matter in their current agenda. As an ordinary Muslim, I must express my concern that by importing the element of interest into the Islamic banking system we indirectly acknowledge that the interest rate of conventional banks is not an evil thing.

On the other hand, we Muslims are constantly being reminded that interest is strictly prohibited by the Quran and Hadith. Therefore, as long as it falls within the scope of interest as defined by Shariah, it must be questionable whether it is appropriate for Islamic banks to associate themselves with this element.

Since numerous scholars insist that no Islamic bank should use market rates of interest as a benchmark, these Islamic banks may retaliate by asking many hypothetical questions related to various aspects of business, especially in the areas of marketing, financing and costing.

The banks are worried that customers may find their products unattractive if the financial consideration differs from the products of conventional banks. They are also concerned that adequate rewards must be given to their depositors, at least comparable to those received by depositors at conventional banks. The Islamic banks will also require scholars to supply them with an alternative mechanism which can assist them in fixing their profit-sharing and mark-up ratios.

In addition to such hypothetical questions, those who have been infused with the idea of using interest rates as a benchmark will hold to the opinion which says that the interest

rate is just a mathematical device to measure the relationship between two quantitative variables. The percentage or figure has nothing to do with halal or haram. A halal factor remains halal whether it is measured as a percentage or otherwise. Similarly, a haram factor remains haram whether it is measured as a percentage or not. Furthermore whatever Allah permits, man cannot prohibit.

It is not my intention to supply the alternative mechanism as required by the existing practitioners. In this article, however, I would like to draw the attention of those who are directly or indirectly involved in the Islamic banking system to the issue which I consider to be the root cause of this phenomenon.

Let us begin with a short history of conventional banks. These institutions were first started as places where the public could store their valuables for safe-keeping. Instead of rewards, charges were imposed on this service.

Over time, these institutions developed and more products and services were made available to the public. Then for several reasons, interest came into the picture. One of the reasons for the inclusion of interest in the system was the belief that those who were willing to part from their liquidity (cash), or were willing to abstain from present consumption should be rewarded accordingly. This reward was known as interest.

By upholding this definition, conventional banks are continuing to reward their depositors. They no longer see banks as custodians of their valuables, but look to these institutions as sources of monetary reward. Similarly, the functions of banks have changed over time. Having started as centres for keeping peoples money, they began giving loans with interest to borrowers.

The interest charged to borrowers not only compromises the reward that banks expect to receive because of their willingness to part with liquidity (cash), but also covers the reward to be paid to depositors.

In order for conventional banks to make profits, the interest rate charged on borrowers is usually higher than the rate paid to depositors. In more sophisticated terms, 'gap manage-

ment' (i.e. the technique which links the interest charged and the interest paid) is introduced. The wider the gap, the more profits the banks will generate, and vice versa. The level of these rates are very much influenced by market forces, that is, the demand and supply of funds.

In summary, two important elements emerge from this overview. First, the acknowledgement by conventional banks that those who are willing to part with their liquidity must be rewarded. Second, the recognition that they have to charge their borrowers at a certain interest level which is sufficient to cover their profits and rewards to depositors. Therefore, the critical question here is: "Should those who are responsible for

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formulating policies and managing Islamic banks concord to these two elements?"

If it is true that existing Islamic banks are using interest rates as a benchmark in fixing their profit-sharing and mark-up ratios, it is possible that the management of these banks are still being influenced by the definition of interest which was propagated by Western thinkers.

As a result of this belief, the cost of funds will become an important element to Islamic banks when fixing their profit-sharing and mark-up ratios. This could be the reason why some people comment that there is little real difference between Islamic and conventional banks. Similarly, this could be the cause of complaints that

charges imposed by Islamic banks are similar to the charges of conventional banks.

For the sake of discussion let's ask this hypothetical question: "is there such a thing as a cost of funds for an Islamic bank?"

This question is one of the main sources of controversy among Islamic banking scholars and banking practitioners. Some scholars believe that there is no cost of funds for Islamic banks, this is because deposits facilities at Islamic banks are governed by the principles of Qard e-Hassana, Wadiah and Mudaraba. These principles never promised rewards at the beginning of deposits. Rewards will only be paid to depositors based on profits generated by those deposited funds, or at the discretion of the banks themselves after a certain period of time.

If we accept the scholars' opinion that there is no cost of funds in Islamic banking, there should be no reason for Islamic banks to use market interest rates as a benchmark in fixing their profit-sharing and mark-up ratios. No cost of funds means the charges imposed by Islamic banks to their users of funds should be very much lower than the charges of conventional banks.

By charging below the market rate, people will be able to say with confidence that Islamic banks are different from conventional banks and their existence is for the betterment of Islamic communities.

Contrary to this view, however, there are people in the Islamic banking system who believe that depositors must be rewarded for their deposits. It is considered an injustice not to reward depositors. If there is an intention to reward the depositors, inevitably the cost of funds becomes an element in the Islamic banking system.

Similarly, if the management of Islamic banks believe that depositors are expecting rewards equivalent to those on offer at conventional banks, the same level of cost of funds will be used in fixing the profit-sharing and mark-up ratios between the banks and borrowers.

There are several serious repercussions if the management of Islamic banks believe that depositors at

Islamic banks possess similar attitudes to those at the conventional banks. The interest rate will continue to have an influence on the operations of Islamic banks as long as this thought remains in the mind of their management.

I am still seeking the truth in the statement which says that it is an injustice if depositors are not rewarded. Similarly, I wonder whether depositors will withdraw all their deposits in the case where Islamic banks are unable to distribute any profit to their depositors.

In 1984, Kuwait Finance House did not distribute any profit to their depositors, but there was no evidence of massive withdrawal of deposits. Currently, this bank still remains in business and has become one of the biggest financial institutions in Kuwait. Similarly, Islamic banks in Sudan never reward their current account holders, but a bulk of their funds is supplied through the current account facilities.

But already some empirical research has found that people who patronise Islamic banks are looking for monetary rewards. We should not blame the majority of depositors for selecting profit as their main reason for patronising Islamic banks. This is because they have been in contact with conventional banks for many years. The profit-motive attitude is reinforced by the capitalist system in which wealth has become a prime focus of life.

Why should Islamic banks continue to act as conduits for those who are placing wealth (returns from deposits) above all other objectives when making deposits? Similarly, why should the management of Islamic banks operate on an assumption which has been embedded in conventional banks for generations. As institutions whose foundations are based on religious doctrines, it is the responsibility of Islamic banks to take immediate steps by reshaping the attitude of their depositors.

The prime objective of this remodelling process is to indoctrinate Muslims with principles which are supposed to dominate the economic behaviour of Muslims. These principles comprise the belief in the Day of Judgement and the life in the hereafter,

the Islamic concept of riches, and the Islamic concept of success. All of these principles are expected not only to have a significant impact on the decision-making process of Muslims, but also to have an influence on their perceptions of Islamic banks.

The first principle has an effect on the depositors' behaviour and their decision-making process. The choice of action is based not only on the immediate financial returns but also on those returns in the hereafter. Therefore, the decision to place deposits with Islamic banks is not because of a profit motive but rather to gain the blessing of Allah.

One of the ways to gain this blessing is to support any programme which will improve Muslim communities. Since Islamic banks operate on an interest-free basis and their establishment is designed to improve Muslim communities. Muslims who support these banks are therefore considered people who achieve salvation as indicated by Verse 20 of Al Tawbah.

In the case of the second principle which involves wealth, Islam has given a clear guidelines to be followed by Muslims. In Islam, wealth is a bounty from Allah and is a tool that may be used for good and evil. Poverty is, in some instances, associated with disbelief and riches are considered a gift from Allah. Wealth itself is considered as an important means by which man can pave the way for attainment of his ultimate objective. All persons are exhorted to work to earn a living and to accumulate wealth. Accumulating wealth is considered among the highest blessings bestowed on man and everyone is encouraged to strive for wealth (Verse 10 of Al Jumu'ah).

The methods of earning, possessing and disposing of wealth, however, must be in line with the Shariah. The best method of accumulating wealth as defined by Shariah, is by striving to succeed on one's own and not from income generated from other people's efforts. This is in line with many Hadiths in which the Prophet had given his advice to Muslims to work for their own food. Therefore, in line with these Hadiths, Muslims should not regard rewards from Islamic banks as a source of income.

The Islamic concept of riches also serves as an important factor which influences Muslim attitudes towards the existence of Islamic banks. Islam defines success as the level of obedience that may be rendered by the positive use of the capabilities and resources given by Allah.

According to Islamic teachings, if a man really wants to serve Allah, the utilisation of the natural and human resources made available to him is not only a privilege, but also a duty and obligation prescribed by Allah. This is in line with Verse 27 of Al Anfal which commands Muslims not to betray the trust given by Allah and his Apostle. Applying this principle to the banker-customer relationship would mean that the customer should not be discouraged by the low profits or limited success of Islamic banks.

In light of these principles, Islamic bank customers are expected not to be guided by the profit motive. Instead, the reason for placing their monies with the Islamic banks is directed towards receiving a blessing from Allah, and this action is considered the best way of managing the resources given by Allah. Since it is a belief of every Muslim that all properties belong to Allah, returns on their deposits are also considered a gift from Allah irrespective of amount. Similarly, in the case of loss it is also from Allah.

There are a few prerequisites which must be followed before the process of reshaping depositors' attitudes can be introduced. One of these principles is that the management of Islamic banks should have the courage to discard the assumption that, depositors must be rewarded at a level similar to the rewards of conventional banks.

Similarly, the changes cannot be introduced as long as management holds firm to the opinion that an Islamic bank is a commercial bank which offers interest-free products. If these prerequisites are unrealisable, there is the possibility that interest rates, profit-sharing and mark-up ratios are indeed in an unbreakable marriage.

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