RIBA IN PROFIT AND LOSS SHARING FINANCING: POLICY IMPLICATIONS

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ABSTRACT

Islamic structural change in the banking sector, apparently initiated in the wake of international Islamic zeitgeist of 1970s, was formally launched phase-wise in Pakistan effective from July 1981 with the abolition of interest in the spirit of article 31 of the 1973 Constitution. But, the introduction of various Shariah-compliant financial instruments including the Profit and Loss Sharing which initially triggered instant stupefaction in the well-entrenched traditional interest-based economy, ultimately reconciled with these quasi-conventional banking products based on different interpretations of the Islamic Law. This paper explores various constrains which hamper the potential growth of emerging Islamic banking system vis-à-vis elimination of riba in the context of monetary policy. The elements of interest constituting riba and the susceptibility of the profit-and-loss sharing to riba in the presence of market imperfections are being highlighted. Besides, while examining the connecting theme of riba, interest and profit sharing relevant to the mode of banking finance, the consequential policy implications are being empirically evaluated within the neo-classical paradigm in the domain of ideologically oriented epistemology.

Keywords: *riba*, *bai*, profit-and-loss, interest, Islamization, co-financier, capital, risk-taking, *mudaraba, musharaka*

INTRODUCTION

Banking in Pakistan commenced with the termination of agreement with the Reserve Bank of India on 30th June 1948. However, gradual expansion in banking system failed to deliver in inducing equitable growth and distribution of wealth in the country to the extent that by 1973 some 200 families which absorbed 75 per cent of bank advances and loans were benefiting from it (Fahim, 1987:16). Thereafter, the banks were nationalized through Banks (Nationalization) Act 1974 to diversify the credit flows in favour of small borrowers and traditionally neglected sectors through prescription of mandatory targets. Yet, the problem of glaring concentration of credit in large accounts persisted because the cost of bank credit continued to be very low and, given the low interest rates, big businesses stood to gain immensely thus bearing adverse impact on income distribution as well as monetary stability. In such circumstances, after 1977 General Mohammad Ziaul Haq, President of Pakistan, sensing interest-free banking as a panacea to the ills afflicting banking sector, promulgated the Zakat and Usher Ordinance 1979, as a prelude to economic system based on Islamic justice. Subsequently, the interest-free banking was formulated under the recommendations of the Council of Islamic Ideology in its report of June 15, 1980. It may be mentioned here that before the full introduction of such a banking system effective from 1st July 1985, the money kept with a bank was a sort of loan to the banker and the data on scheduled bank advances by size of accounts and borrowers reveal that at the end of March 1985, as much as Rs.22.95 billion or 35.54 per cent of the total bank advances to the private sector was preempted by only 921 borrowers representing merely 0.11 per cent of all borrowers (Institute of Policy Studies, 1986:13). However, with the induction of economic Islamization in Pakistan in 1980s, the mode of Islamic banking disseminated myriad aspects of financial instruments and related planning mechanism impacting on the economy of Pakistan. Although evaluation of economic brunt of such a system is beyond the scope of this paper, it is intended to analyze the legitimacy of profit and loss sharing in the entire financial system of country as an ideal Islamic substitute based on the principles of *musharaka* and *mudaraba* requiring business firms to share actual profits-losses.

Since Pakistan was created in the name of Islam, the religio-political segment of country always hankered for introducing interest free system to transfer the economy purged of *riba* in line with the ethos of the value system of Islam. In this connection, the relevant Quranic verses which prohibit *riba* are Al-Baqara (2: 274-280), Al 'Imran (3:130) and Al Rum (30:39). But, there is no direct definition of *riba* in the Quran and the term may be defined by interpreting its contextual meaning. The question is not about *riba* per se but about the contextual definition of *riba* as enunciated in the revelation (Qureshi, 1946:6). The Holy Quran in the verse 275 of chapter 2 narrates:

> "Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury".

This verse purports that *riba* is forbidden while *bai* is allowed because of their distinguishing properties. Literally *bai* means sale but in the context of the verse *bai* means trade implying economic activity. Trade is Islamically legitimate because it satisfies the criterion of justice and equity. Therefore, *bai* possesses some such attributes due to which it is Islamically permissible, while *riba* by contrast must be a negation of those qualifications. By characterizing the essential attributes of *bai*, it is possible to operationally define *riba* as a contrast to *bai*.

Trade is exchange of values, value for equal value as evident in barter transactions. The buyer pays for the value received and the seller receives the payment for the value given equally. One value equals the other. Equal values are exchanged against each other. Such equality of values, be it exchanged in terms of money, is in fact the essential basis of trade. No actor receives excess value at the expense of the other. *Riba* means excess. Contextually, it has been defined 'an increase or excess or unearned value which, in an exchange or sale of a commodity, accrues to one actor (lender) without giving in return any equivalent counter-value or recompense to the other' (Haque, 1985: 16). In this sense, *riba* being contrary to justice and equity is simply excess value, while there is no excess value in *bai*. However, due to lack of precise definition of *riba* it is generally assumed that the pre-determined interest is *riba* while profit-and-loss sharing is free from *riba*.

REVIEW OF LITERATURE

The conceptualization of banking practices based on the economic ideals of Islam in Pakistan can be evidently traced from Quaid-i-Azam's observation that "the adoption of western economic theory and practice will not help us in achieving our goal of creating a happy and contended people" (Burke, 2000:231). Likewise, few scholars presume that Pakistan being an ideological state the abolition of *riba* has been from the very beginning an objective of the state policy (Institute of Bankers in Pakistan, 1982). However, Ritcher (1979: 547-57) and Khan (1987:7-12) illustrate Pakistan embarking on Islamization of financial institutions in the wake of international economic resurgence of 1970s, a phenomenon which had resulted in the Islamic banking movement. It was further strengthened with the setting up of International Association of Islamic Banks in 1977 and host of related institutions. Apart from the differing views on the genesis of Islamic banking in Pakistan, there also happens serious discussion over the interpretation of the holy revelations concerning *riba* whether it relates to loans of personal nature or of commercial type, for consumption purposes or for productive purposes, for government borrowing or for private concern, for high or low interest rates, and for compound interest rather than simple interest. One section of Muslim scholars (traditionalists) opine that the *riba* stands for interest in all its forms and manifestations and point to the Quanic reference to declare war against those who indulge in it (Maudoodi, 1961; Siddiqi,1961; and Qureshi, 1946). They are of the view that pre-determined rate with fixed period on capital come in the ambit of *riba* and is thus divinely forbidden. On the other side of the divide, secularists in Islam believe that owing to the competition for supply of funds the banks operate under risk-taking, therefore, the modern banking does not fall in the domain of *riba* (Pal, 1994). In an other strand, Professor Fazlur Rehman (1964) emphasizes the chronological order of revelation in order to appreciate the prescriptions regarding *riba*. He argues that the doubling and re-doubling the principal amount mentioned in the Surah Al 'Imram (3:130) as a penalty for failure to repay the loan and thereby exorbitant increment for stipulated extension of the term is explicitly forbidden (Rahman, 1964:5). However, for eliminating interest from the economy, the Report of the Council of Islamic Ideology on Eliminationg of Interest from the Economy provided alternative system of profit and loss sharing (PLS) conforming to *shariah* in letter and spirit. Soon, the issues of the provision of shares in lieu of the loss and the system of compounding of mark-up in the PLS arrangement cropped up. These misgivings were later apparantely addressed by indepth examination of all the hurdles that stood in its implimentation (Khan, 1991). Taking cue from them, this paper surveys compatibility of Profit and Loss Sharing as envisaged in the Islamic injunctions regarding prohibition of *riba* and examines its workability in a malfunctioning economy within the neo-classical paradigm.

INTEREST AND *RIBA*

Interest is predetermined price of capital, and commonly the pre-determined rate linked to the period of utilization is susceptible to *riba*. The general assumption or the popular belief that interest is *riba* is not valid. Interest like any other predetermined factor price contains an element of *riba* but the entire interest is not *riba*. The rate of interest reflects the expected productivity of capital which may exceed or fall short of its actually realized productivity. Either situation is vulnerable to *riba*. The element of *riba* in a factor price is measured by its variance from the actually realized productivity of the factor. Any excess or shortfall in relation to productivity is *riba* for one or the other actor. Overpriced capital produces *riba* for lenders. In the contemporary system of financial intermediation this *riba* arises to the banking system. This occurs in monopolistic and cartelized markets due to artificially created shortages. In the opposite case when capital is under-priced *riba* arises to borrowers, i.e. to entrepreneurs. A *riba*-free price does not contain any element of unearned value for any actor in the exchange transaction. Existence of *riba* reflects the presence of monopolistic elements in capital markets or a policy bias in favour of disequilibrium rates of interest. In the ideal case in which the expected productivity of capital is equal to its actually realized productivity, the rate of interest will reflect equilibrium rate of interest in a purely competitive market of capital. The true price of capital and in that case interest will not contain any element of *riba*. However, *riba* may also exist in pure competition in the short run during the process of transition from one equilibrium position to another.

In developing countries like Pakistan, capital is seldom overpriced; rather it is generally under-priced. The purpose of maintaining low, disequilibrium rates of interest is to keep down the cost of capital and thus encourage growth of investment (Meenai, 2004: 46). The existence of *riba* in the low, disequilibrium rates of interest which accrues to entrepreneurs is tolerable in the largest social interest because it encourages the growth of investment which, in turn, leads to increases in employment and output. Ultimately, the benefit is generally shared by the whole society; firstly, because more job opportunities are created; secondly, because expansions in output help in releasing the price pressures; and finally, growth begets growth which paves the way for achieving generally rising levels of prosperity. But, if entrepreneurs' response to this policy incentive is not positive, in that case the benefit will simply end up as an unearned excess value in profits resulting in *riba*. In such a circumstance, policy adjustment must not aim at correcting the interest rate because it will dampen growth by increasing the cost of capital, but attempts must be made to improve entrepreneurs' response to the incentives of low interest rates by expanding output and employment.

A *riba*-free economy is a fair price economy in which each productive contribution is justly rewarded – no more, no less. This is a goal which every egalitarian economic system, especially Islamic society, aims to achieve.

PROFIT-AND-LOSS SHARING

The PLS financing is a contract which stipulates sharing of profits in mutually agreed proportions fixed in advance between the owner and co-financier with bank as an intermediary; however, losses are shared proportionate to capital. From an Islamic perspective, the PLS gets significance if the source of profit is based on some form of productive activity devoid of *riba*. It may be mentioned that the term 'profit' is not used here in the same sense as in economics. In this system, profits are defined as a composite reward for the services of three factors of production: return on capital, reward for managerial services and the reward for risk taking. These components are all inseparably amalgamated in one indivisible complex whole, called profits. The flexibility in profit sharing proportions that the owner and the co-financier may not share profits proportionately to capital, which the system permits is indeed due to the unique nature of profits. The basic purpose of this flexibility is to allow the owner and the co-financier to base the profit sharing proportions to both the mutually agreed assessment of the expected risk involved in the project and the quality of managerial efficiency of the owner; perhaps, more importantly to the latter. Indeed, were it not so, the system would have prescribed that profits be shared proportionate to capital. Even though the function of risk taking is performed jointly by the owner and the co-financier, it is the owner who has to attract the co-financier to join him in risk taking. The higher the risk, the larger the share in profits, which the co-financier would demand. The co-financier's share in profits will vary positively with the amount of risk involved in the project. In situations of equal risk also, the profit sharing proportions would vary from one case of co-financing to another. This is due to the varying expected contributions of the managerial input to profits. As a general rule, the higher the expected contribution of management to profits, the greater would be the owner's share in profits. On the other hand, the co-financier's share in profits would vary inversely with the expected productivity of management. The flexibility in profit sharing proportions which the system permits has a dual significance. Not only is it aimed to provide a built-in reward for his managerial efficiency to the owner but it also incorporates guarantee to the co-financier against the managerial inefficiency of the owner with the higher share. In this sense, the profit sharing proportions differ from the capital sharing proportions.

ISLAMIC LEGITIMACY OF PROFIT-AND-LOSS SHARING FINANCING

The Islamic legitimacy of PLS financing is most probably more by permissibility and practice than by prescription. The system is not manifestly prescribed by any holy revelations (Ahmed, 1989). Nor is it known whether the system was actually introduced by the Holy Prophet Muhammad [peace be upon him] or it was also prevalent in the Arabian communities or elsewhere even before the rise of Islam and the Holy Prophet Muhammad [peace be upon him] simply approved its adoption by Muslims in preference to the widely prevalent system of usury (Udovitch, 1970: 17). But, permissibility must not be construed as prescription, much less an injunction. However, the PLS financing was adopted to eradicate usury because it was more equitable as well as more efficient and productive than usury but probably no sanctity of holy injunction was attached to it. In replacing the usurious money lending, the PLS financing marked the essential first step towards the development of capital markets. Before its rise, there did not exist a basis for the pricing of capital. By linking the rate of capital to profits, the system provided a logical basis for the pricing of capital. This was a great breakthrough. Money lending was now replaced by project financing. The system provided a basis for evaluating the viability of investment proposals, a built-in check against infeasible and non-viable investments and a basis for rational allocation of capital. Only competing projects with strong viability could attract co-financial assistance. The system encouraged the growth of venture capital and entrepreneurship. It was certainly more equitable and just than usury as well as it had a sound rationale of participatory financing based on the principles of *mudaraba* and *musharaka*. Also the system linked the price of capital to its productivity and thus it had the capacity to eliminate *riba* from the price of capital. This capacity of the system was, however, subject to the condition that mutually agreed proportions of profit sharing between the entrepreneur and the co-financier would reflect the true contributions of enterprise, management and capital – no actor receiving excess value at the expense of the other. It was perhaps due to these advantages of the system that usury was condemned and replaced by PLS financing.

PROFIT SHARING FINANCING AND *RIBA*

Since co-financier's share in profits comprises two elements: a return on capital, and a reward for his participation in risk taking; while assessing the mutually agreed proportions in profit sharing each element is evaluated in advance on the basis of expected productivity of capital and enterprise. In this way, both elements, the return on capital as well as the reward for risk taking, are thus built into a share in profits on the basis of the expected productivity of each. Since the actually realized productivity of either capital or enterprise or of both may differ from its expected productivity, a mutually agreed share in profits which the co-financier may receive may not also reflect the actually realized productivity of capital and enterprise entailing *riba*. As we know that the root cause of *riba* is predetermined factor pricing, if a factor price is predetermined, it will potentially produce *riba* for one or the other actors in the transaction. This is because the actually realized productivity of the factor may differ from its expected productivity on whose basis its predetermined price was mutually agreed and fixed. Perhaps, it is a near impossibility to achieve *riba*-free factor prices in a regime of unequal countervailing powers. Co-financiers can squeeze the entrapped entrepreneur and thus extract an unduly larger share in profits than would be justified by their participation in financing and risk taking. The reverse could also be true when the potential co-financiers are stuck up with a surfeit of excess liquidity. It is highly unlikely that the entrepreneurs and the co-financiers shall have equal countervailing powers, neither actor being weaker than the other. The system, unless it is externally regulated to protect the weak, will continue to produce *riba* for the stronger actor because the stronger will sway the profit sharing proportion to his favour. Therefore, the PLS financing is as much susceptible to *riba* as is the interest-based financing in modern banking. This is because the system is based on predetermined factor pricing of capital, enterprise and management and is also subject to price distortions due to unequal countervailing powers of entrepreneurs and co-financiers in the prevailing imperfect and monopolistic market conditions.

CONCLUSION

From a policy making point of view as well as theoretically the objectives of achieving a *riba*-free rate of interest is conclusively synonymous with the objective of promoting smoothly functioning competitive markets of capital. So long as market imperfections and monopolistic elements cannot be eliminated completely and the capital and financial markets continue to remain less than purely competitive, either system, interest-based financing as well as profit-sharing financing, will always remain prone to *riba*. Consequently, the element of *riba* cannot be eliminated completely though it could be reduced through external regulation. Perhaps, the policy objective for eliminating *riba* from the financial system in Pakistan should be sought in terms of reducing the market imperfections, eliminating manipulative activity and promoting free interplay of market forces with a focus on equity and social justice in the light of the teachings of Islam.

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