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Banking Without Interest

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Professor Siddiqi's *Banking without Interest* was first published in Urdu in the late 1960s. An English translation was brought out by Islamic Publications Ltd., Lahore, in 1973; it was reprinted in a third (unchanged) edition in 1980. The Islamic Foundation presents *Banking without Interest* now (1983) in a corrected and substantially improved translation of the original Urdu text, but without any revision or updating of its substance and content. Thus the author has to concede in his preface (written in 1981): "The readers' expectations from a book on interest-free banking published in the eighties will most likely be more than this translation can satisfy". So why the re-issue of this book?

The main reason given by the author in his preface and by Khurshid Ahmad in his Foreword is that Banking without Interest has a historical value as the first book-length treatment of this subject. And since the subsequent development has "not drastically modified the basic model incorporated in this book it deserves preservation". (Preface). The historical value of Professor Siddiqi's model is beyond all doubt, but for the ordinary reader it should also have an actual value, i.e. should give him something that he cannot find in the same or even better presentation somewhere else. Now, does Professor Siddiqi's book have such a value?

Yes, it has. To the reviewers limited knowledge of only the published English language literature on Islamic economics, Professor Siddiqi's model of an interest-free economy was the first and is one of the very few models that outline the micro and macroeconomic functioning of a financial system based on profit and loss sharing (PLS) instead of interest within the institutional framework of a market economy (composed of private entrepreneurs and private PLS banks and without a dominant and direct public interference into and planning of the capital formation and allocation). Despite several shortcomings it is still a thought-provoking and inspiring approach which deserves attention and further elaboration in our days.

Roughly speaking, the model unfolds the (microeconomic) principles for the business of profit-oriented PLS banks and describes (macroeconomic) tasks and instruments of the monetary authority in an interest-free system.

Professor Siddiqi does not specify his reservation that his old text most likely will not satisfy the expectations of a reader in 1983. In the reviewer's opinion one important reason is that the title of the book is so embracing and unconditional that it must create expectations with which it can never come up. It would have been a good idea to add to "Banking without Interest" a specifying sub-title indicating what issues are covered and what is left out. A possible sub-title might have been: An Economic Introduction into Basic Principles of PLS Banking in a Closed Interest-Free Economy". This should indicate

- that the book does not deal with the theological or legal aspects of the Islamic prohibition of interest but presents an economic discourse on how to build-up and run an interest-free economy;

- that the book was not written for those who are already experts in Islamic banking but that it tries to explain basic features of PLS banking (like the different forms of business partnerships, the principles for the distribution of profits and losses according to these contracts, or the process of credit and money creation in an interest- free system);

- that the book deals only with principles and does not refer to the practice of Islamic banking today;

- that "interest-free banking" is synonymous with "PLS banking" and that other forms of interest-free financing which are applied by operating Islamic banks (like leasing, hire-purchase, mark-up sales) are not subject of the book;

- that the model is restricted to financial transactions within a closed economy which has no economic relations with other Muslim or (may be more intresting) non-Muslim countries so that problems of the financing of international trade, of international capital movements, of exchange rate regimes, etc. are excluded;

- that a crucial premise of the model is that interest is completely abolished in the whole economy where PLS banks operate, i.e. that the interest-free are the only banks in the economy and that they do not have to compete with conventional interest banks (as the existing Islamic banks today have), what of course would have an influence on all calculations of entrepreneurs, banks, and savers and should be considered with respect to banking laws and regulations and in the monetary policy.

But even if the reader takes notice of all these restrictions and qualifications and especially does not expect a treatise on present-day Islamic banks, the book can hardly satisfy all his expectations if he is a professional economist and quite familiar with the recent state of economic theory. He will find that the text is more descriptive than analytical and (esp. in the chapters the creation of money and the Central Bank) somewhat lengthy and that arguments are often rather mechanistic. Such a judgement, however, is based on today's state of economics, and one should not forget that there were remarkable advances in those fields of economic theory in the 1970s which are of highest

relevance for the subject of Professor Siddiqi's book, for example in the monetary theory and in theories dealing with the role of social institutions in the process of the reduction of information costs. Therefore if there are, from a present-day point of view, analytical and theoretical shortcomings in a text of the late 1960s, it seems more appropriate to take this as an incentive for a revision and supplementation of the old model than to confine oneself to just an overall critique of the model as "outdated".

The model assumes that the interest-free banks will base their business - both with the capital demanding entrepreneurs and the capital providing depositors - mainly on profit and loss sharing (PLS) arrangements, complemented by deposit and loan contracts which are free of any interest or other financial allowance.

In PLS arrangements the profits of a specific project or of a company are distributed to the suppliers of capital in proportion to their shares in the total (loan-term) capital employed in that project or company and to the entrepreneur who will receive from the capital suppliers a share in their profit for his managerial efforts. This entrepreneurial share is negotiated between the capital suppliers and the entrepreneur and is fixed as a percentage at the time of entering the PLS arrangement. Losses must be borne by the capital owners proportional to their capital shares.

Professor Siddiqi distinguishes two types of PLS arrangements with respect to the participation of the capital suppliers in the management of the project or company: (1) In a "partnership" arrangement the capital providing party has a full right to participate in the management (although there is no need to execute this right actually). In a "*mudaraba*" arrangement the capital providing party has no right to interfere into the management. It must be noted here that this use of terms is somewhat different from what is ordinary in Islamic banking today:

- That the type of PLS arrangements which is named "partnership" or "*Shirkat-e-Enan*" by Professor Siddiqi is commonly known in Islamic banking as "*musharaka*" (or sometimes "participation") is just a question of words. However, to prevent confusion, it would have been useful to mention the alternative terminology at least in a footnote (which unfortunately was not done).

- The following difference is one of substance, and the possible confusion resulting from divergent contents of "*mudaraba*" is more serious. For operating Islamic financial institutions (like *Dar al-Maal al-Islami*), it is an essential feature of *mudaraba* (also named "*qirad*" or "trust financing") that the entrepreneur does not provide own capital in a project financed by a *mudaraba* arrangement but only his expertise and management efforts. One implication of this definition is that already operating companies cannot receive capital on a *mudaraba* basis; another implication is that money deposited with a bank in a *mudaraba* arrangement should not participate in the total profit of the bank (since this results from the use of deposits and of own capital of the bank) but only in the profits of specific "*mudaraba* projects" managed by the bank but financed only by the *mudaraba* deposits.

Professor Siddiqi does not mention this criterion that in *mudaraba* arrangements the entrepreneur does not employ own capital. But if one accepts this criterion and uses the

terms in the way the Islamic banks use them today, then quite a number of Professor Siddiqi's examples for *mudaraba* financings must be re-classified as illustrations for *musharaka* arrangements. These conceptual differences require some clarification in the text or at least in a footnote of the 1983 issue, but one cannot even find one word about it.

Professor Siddiqi points out that in PLS financing the bank and the capital demanding entrepreneur agree upon a ratio of profit-sharing; he also mentions that the entrepreneur can acquire additional capital only with the consent of the bank. But he does not comment on the implications of this need of consent for the resulting power banks can get over entrepreneurs even if they have (in a *mudaraba* contract) no right to participate in the orderly management decisions. And Professor Siddiqi does not state explicitly why there is a need for the bank's consent into the acquisition of additional capital. The reason for this is as follows: since, according to Professor Siddiqi, the profit of an enterprise is distributed in a first step in proportion to the capital employed in it, an increase of the total capital from other sources than the bank means a reduction in the bank's share in the total capital and consequently in the share of profit allocated in the first step. If the (expected) profit does not rise with the same (or even a higher) percentage as the total capital, the value of the profit share allocated to the bank in the first step will decrease, and if the ratio of profit-sharing is not changed the absolute amount left to the bank will be smaller than originally expected when entering the PLS arrangement. Therefore the bank will give its consent to the acquisition of additional capital only when its ratio of profit-sharing (rps) will be increased so that the absolute amount of the share of the expected profit (PB) will keep the same as originally. Let bsc denote the bank's share in the total capital and P the expected profit of the enterprise (which was accepted by both the bank and the entrepreneur when entering the PLS contract); then PB can be calculated as $PB = bsc \times rps \times P$.

Agreeing on P, the bank and the entrepreneur negotiated on rps assuming a given bsc. For the bank it is not rps in itself that has a meaning but the resulting expected returns on the provided capital, PB. Under the above assumptions it would be equivalent if the bank and the entrepreneur negotiated for PB and would subsequently calculate the respective rps. But if they would not fix rps but PB in their PLS contract this would give the entrepreneur more flexibility in the acquisition of additional capital: Unless the expected profit P decreases the fixing of PB will protect the interests of the bank because a decrease in its bsc causes automatically an increase in rps so that the reduction in the profit allocation in the first step (proportional to the capital shares) would be compensated by an increase of the share allocated to the bank in the second step (according to rps).

Professor Siddiqi argues that the relations between the bank and its depositors could also be structured along the PLS line and he suggests that the bank should create "*mudaraba* accounts" for depositors. However, he does not elaborate on how to allocate the profits to these accounts. The problems here are in principle the same as those just mentioned, but it is absolutely impossible that each *mudaraba* depositor should give the bank his consent to changes in the total amount of *mudaraba* deposits. Therefore the contract between the depositors and the bank cannot just state a specific ratio of profit-sharing for the depositors but must express something analogous to PB in the above example. To give an idea: The contract could stipulate that the bank will pay for each deposited Rs. 100 an amount on Rs. 1/x per each Rupee of profit made by the bank.

Considering the financial needs of the enterprises on the one hand and the preconditions for the practicability of PLS financings on the other hand, Professor Siddiqi states the need for the provision of non PLS short-term financing by the banks in order to meet the entrepreneurial demand for working capital. He suggests that the banks should provide loans which are free from interest but also from any other (direct) financial burden. In contrast to PLS capital these loans have to be repaid in any case, i.e. even if the enterprise makes a loss, and the bank can ask for adequate securities.

The funds for these loans should come from deposits in "loan accounts" for which the banks offer no financial allowances but facilities identical to those of conventional current accounts (for demand deposits), e.g. the safety of the deposited money, cheque-books, payments by bank transfers, etc. There would be no need for the banks to employ all "loan deposits" in free loans for entrepreneurs but the banks could use substantial parts of these deposits for profitable PLS financings. This makes it attractive to receive deposits in loan accounts from the public. But what are the incentives for the banks to advance free loans to the entrepreneurs?

In Professor Siddiqi's model the strongest incentive should come from a regulation that any PLS bank not willing to advance free loans will not be allowed to accept deposits in loan accounts (which get no remunerations but can partially be employed in profitable PLS projects by the bank). Professor Siddiqi suggests also that the Central Bank should fix a "lending ratio" as a relation between the bank's long-term PLS credits and the short-term loans to be advanced to the entrepreneurs. This lending ratio should even become an instrument of the monetary policy and the Central Bank should try to establish an equilibrium between the demand and supply by discretionary manipulations of the lending ratio (see pp.63-65 and 121-124; note that in the table on p. 123 under "Assets" it must read "Loan" and "Mudaraba" instead of "Loan Acct." and "Mudaraba Acct.").

The model is not very convincing here. If we assume that the banks provide entrepreneurs with long-term capital on PLS basis and that these entrepreneurs need also short-term capital to run their business, then it should be in the own interest of the banks to provide the entrepreneurs with the short-term loans also. Otherwise the entrepreneurs would not be able to run the business with the expected profits in which the banks participate. For this reason, the banks might provide loans even from money deposited in *mudaraba* accounts if this secures the expected profits. So it is not conclusive that the total supply of interest-free loans will depend on the total deposits in the loan accounts. More important: There is no need for regulations concerning a "lending ratio" and for its manipulations by the Central Bank - neither as an incentive for the advancement of loans, nor in order to reach an equilibrium between demand and supply. Even if the demand for interest-free loans were indefinite the banks have to calculate internally how much of their deposits they should employ in loans and how much in PLS credits, and they will also calculate how to allocate the funds in the most profitable and efficient way.

Suppose two new enterprises, A and B, shall be established and they both need the same long-term PLS capital but B needs more short-term loans. If a bank can only satisfy the demand of one entrepreneur and if it cannot get any compensation from B, then it would allocate the funds to A. A "compensation" from B must be or result in a PB higher than that of A. This difference in PB between A and B would be the costs of the additional

interest-free loans for B (so that the demand for loans hardly will be indefinite). It should be noted that there are costs for the loans although they are still interest-free and do not share the profits and (more important) the losses. However, there is no real reason in the model why the short-term loans should or could not be advanced on a PLS basis. One could simply calculate and agree upon a "short-term PB" per loaned Rupee and per day and multiply this with the amount and the period of the loan. The result would be a short-term PLS loan. In Professor Siddiqi's model the "lending ratio" was one of the instrument for the monetary policy of the Central Bank; the two other important instruments are the "reserve ratio" and the "borrowing ratio". The reserve ratio is that percentage of the (loan and *mudaraba*) deposits that must be held in cash by the PLS banks. The borrowing ratio is a relation between the amount of short-term loans advanced by the banks and that amount the banks are allowed to borrow interest-free from the Central Bank in its function as "lender of last resort". Abolishing the lending ratio and looking at loans from the Central Bank as something extraordinary, the main instrument of the Central Bank will be in normal times the reserve ratio. It shall influence the process of credit and money creation. The presentation of this process is not very satisfying. For example, no explicit definition of money is given. No difference is made between deposits in *mudaraba* and loan accounts and both are treated as money. At least according to a narrower definition of money as currency outside banks plus private sector's demand deposits the *mudaraba* deposits are no money, and thus all numerical examples had to be corrected. What must be corrected in any way are the tables on p.82 ("Cash Reserve" belongs to "Assets", not to "Liabilities"). The whole description of the process of money creation is too lengthy and mechanistic, especially if one takes into consideration that the presentation of the multiplier process follows very familiar lines of Western economics.

Summing up, *Banking without Interest* is neither a textbook nor an introduction into present-day Islamic banking, and it cannot represent the actual state of research in monetary Islamic economics. But it does present a comprehensive model of an interest-free market economy which invites and stimulates the reader to think on his own about the subject. The book can be recommended for readers who have already some knowledge of Islamic banking and/or will continue studying this subject. For "beginners" it would have been useful if some more efforts were made to adapt the terminology to today's practice and to outline the position of the model in the broader context of contemporary Islamic economics.

Request PDF | On Jun 1, 2017, Jana Ilieva and others published Banking without interest | Find, read and cite all the research you need on ResearchGate.Â On the top of it is avoiding prohibitions namely interest, uncertainty and practicing banking with profit and loss sharing (Ilieva, Ristovska and Kozuharov, 2017). SSBs in Islamic banks exist for ensuring compliance of all dealings with the religion of Islam. Interest, of course, is pretty fundamental to banking. Stephen Ranzini decided to find out: Is it possible to do what a bank does without charging interest? Music: "Now Son" and "Done Talking." Find us: Twitter/ Facebook. 2 Arab banks are being formed to lend out oil money without interest, which is forbidden by Koran; Dubai Islamic Bank will charge 'handling fee' when advancing credit, and Islamic Development Bank will share in profits accruing to projects financed on govt-to-govt basis (S).Â Continue reading the main story. Banking Without Interest Rates. June 1, 1975. Credit...The New York Times Archives.