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Smart partnership in Islamic banking

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ISLAMIC BANKING today is synonymous with credit banking, only differing from the conventional system by virtue of the contracts applied. Just like loans, the contracts of bay' bithaman ajil (BBA) and al-murabahah are popular because they are easy to use. Islamic banking today is no longer associated with partnership banking as envisioned by early Muslim economists.

The principles of credit-based Islamic banking (CBIB) and partnership banking are different. The former is akin to conventional banking. The latter is revolutionary. Prof Samuel Hayes of Harvard Business School attests to this fact. He says the economic principles of Islamic finance (credit-based) and conventional finance are the same, although the structure of Islamic financial transactions can be different.

But partnership banking is not dead. Prime Minister Datuk Seri Dr Mahathir Mohamad, in delivering a speech at the inauguration of the Islamic Financial Services Board (IFSB) recently, talked about smart partnership and the win-win concept. He said, 'Because in the Islamic system, risk is shared by the lender (bank) and borrower (customer), there should be a win-win situation, for obviously a smart partnership is involved. As a partner the lender must carefully scrutinise the honesty and reliability of the borrower.'

However, as mistakes can still happen, due diligence is therefore more essential in Islamic banking than in the conventional system, where the borrower can always be bankrupted and his collateral seized.

Dr Mahathir further noted that under the risk-sharing principle of Islamic banking, banks have to share losses incurred by an entrepreneur. Banks are not guaranteed to receive income when the enterprise makes losses. This arrangement enhances the long-term commitment to work together as both sides would be accountable for the performance of the enterprise. Under Islamic banking, the issue of non-performing loans would not arise, as any losses would accrue immediately to the banks as well as the entrepreneurs.

Islamic banks, acting as business partners, would therefore go the extra mile to keep good companies afloat in good times and bad, instead of abandoning them by withdrawing credit lines at the first sign of distress. In this manner, the Islamic banking principle of risk-sharing embodies a built-in capacity to contribute to ensuring greater stability in the financial system.

The strong support Dr Mahathir showed for partnership banking might have caught Islamic bankers as well as foreign observers by surprise. Earlier this year, the Prime Minister propagated the idea of the gold dinar. To some extent, the dinar system poses a threat to the supremacy of the US dollar. It also forces Islamic economists and financiers to polish their definition of money and how an Islamic bank would perform under the dinar system. The risk-sharing concept of Islamic banking may not be good news to the West as it goes against the basic principle of debt. The partnership principle is expected to revolutionise the banking industry, including Islamic banks.

The idea of partnership in the banking business as envisaged by Dr Mahathir is quite different from that forwarded by Muslim economists. The model is still based on the contract of debt with the borrower holding no legal obligation to pay back the interest and principal loan in the event

of losses. In this manner, there is no urgent need to amend the banking laws to accommodate control by way of share ownership. To what extent, banks as lenders (that is, not equity owners) are able to monitor or control borrowers is a difficult task indeed. This is because a contract of loan (qard) and a contract of partnership (shirkat) run on different principles.

A contract of loan that stipulates profit-loss sharing is similar but not equivalent to the contracts of musyarakah (partnership in capital) and al-qirad (trustee partnership). In musyarakah, the bank holds a significant amount of shareholding to gain control. The musyarakah framework however, is not in line with BAFIA. Malaysian banking law in principle does not allow banks to practise joint venture in capital. Al-qirad or mudarabah is closer to Dr Mahathir's model since the manager (mudarib) is not liable for capital losses. In the al-qirad model, the bank as a capital provider will bear all losses. The contract stipulates a contractual profit-sharing ratio that spells out the mechanism of profit distribution, if any.

It is expected that legal practitioners will have a hard time dealing with a contract of debt with partnership attributes. This is because in Shariah law, a contract of loan (qard) requires the borrower only to return the principal amount whether he suffers losses or earns profits. Making it an obligation (wajib) to distribute profits or write off losses through capital depreciation under al-qard is only possible if the contract of al-qirad is used instead. As we all know, the contract of al-qirad (mudarabah) is not a joint venture involving joint capital ownership.

The benevolent Islamic banking model proposed by the Prime Minister should not go unheeded. Maybe this is his way of reminding Islamic banking practitioners to reduce al-murabahah and BBA to make way for risk-sharing operations. The principles of credit-based Islamic banking as portrayed by Prof Hayes is similar to conventional banking, which also means it is prone to inheriting the diseases of western capitalism. It is not surprising to see BBA-based financing cut credit line when business is not good. Likewise, BBA financing can push entrepreneurs into bankruptcies.

Bank Negara had made it clear that fixed-rate products such as BBA and murabahah are not able to withstand economic volatility, often leading Islamic banks to underperform.

BBA also supports positive time preference with contractual compensations similar to conventional finance. As the rationalisation of interest is based on the same concept, the future of Islamic banking and finance can no longer rest on credit-based contracts. The West does not see credit-based Islamic banking (CBIS) as a threat to them as it (CBIS) has already embraced the spirit of capitalism. But the same is not true when partnership banking via risk and profit sharing system is in play. It provokes the creditor-debtor mechanism that often favours people with capital and oppresses those without one. It introduces stability in the financial system when business failure does not always mean bankruptcies and business closures.

As indicated by Dr. Mahathir, partnership banking promotes financial stability, as a successful venture will result in a 'win-win' situation to all participants in the financial system while an unsuccessful venture will spread the losses and not confine such losses to one segment of the financial system.

Some observers might find it hard to understand how lending and borrowing under an Islamic system can also embrace profit-loss sharing principle. To be accurate, the contract of debt in Islam is not commercially viable since any increment from repayment cannot be

stipulated upfront. In the case of a loan where the lender holds a legal claim on profit made by the borrower via a mudarabah distribution system, the Shariah position is quite clear. That is, such arrangement falls under the al-qirad model. Here the debtor-creditor relationship changes to that of a capital provider (rabbulmal) and manager (mudarib).

Truly, the contract of debt (qard) in Islamic banking is a misnomer since the bank as a profit-seeking firm cannot make profit from loans. The contract of debt (qard) only applies to the welfare sector. The business sector uses al-bay' (trade and commerce) where the contract of qirad, musyarakah, cash murabahah, ijarah, salam, istisna, wakalah and so on can find ready applications.

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