SHARIAH BASED BANKING AND PROFIT OR LOSS PARADIGM

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ABSTRACT
The popularity of Islamic Banking in practicing nations stimulated the Western banks to adopt Islamic banking. This model works on Profit and Loss Arrangement (PLS) and has its base in Shariah. The novel thought of no interest led to innovations in financial products. But the financial success of an Islamic Bank cannot be compared with conventional banks as they operate under different set of rules. The present paper is aimed at sharing knowledge on Islamic Banking by understanding principles of Islamic Banking; profit or loss paradigm; differences between conventional and Islamic banking; Shariah screening and ethical investment and relevance to Indian context.

Keywords: Islamic Banking, Profit and Loss Arrangements (PLS), Islamic banking and India, Principles of Islamic Banking and Shariah.
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INTRODUCTION

The western style of banking in the Islamic countries during European colonization led to Muslim individuals open accounts in the bank - they felt maintaining a bank account was necessary for transaction purpose but on the other hand refused to accept interest accumulating in their account as it was against Shariah\(^1\). One of the regulations and directive in shariah prohibits riba (usury). The banking system realized the existence of a different set of customers whose needs did not match with the customers of the conventional banks. This led to the development of quasi academic field called Islamic Economics (A study on Islamic financial institutions). The Islamic financial law has long history but Islamic banking and finance industry came into existence with profit and loss sharing investment by Egypt’s Mit Ghamr Saving Banks in 1963 and Dubai Islamic Bank (DIB) is known as world first Islamic bank it was formed in 1975 (Ahmad, 2008). “An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes funds on the basis of a mudarabah\(^2\) or wakalah\(^3\) (agent) contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank, and are guaranteed (Al-Jarhi and Iqbal, 2001)”. For the services rendered under wakalah contract the administrator of funds earns a fee for services rendered. Islamic Banking is incomprehensible for western economies as the concept involves doing banking business without interest and collateral. But in the recent past Islamic banking has grown in size and number of players in other parts of the world. Islamic banking is practiced in, but not limited to, the following countries: Albania, Algeria, Australia, Bahamas, Bahrain, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, North Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, India, Indonesia, Iran, Iraq, Italy, Ivory Coast, Jordan, Kazakhstan, Kuwait, Lebanon, Luxembourg, Malaysia, Mauritania, Morocco, Netherlands, Niger, Nigeria,

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1 Shariah- The Arabic word *shariah* refers to a waterway that leads to a main water source. An analogy can be made where just as water is a necessary element of life, so is Shariah essential to the well-being of a Muslim.

2 “Mudarabah” is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "rabb-ul-mal", while the management and work is an exclusive responsibility of the other, who is called "mudarib". The Mudarabah (Profit Sharing) is a contract, with one party providing 100 percent of the capital and the other party providing its specialist knowledge to invest the capital and manage the investment project. Profits generated are shared between the parties according to a pre-agreed ratio. Only the lender of the money has to take losses.

3 "Wakalah" – This occurs when a person appoints a representative to undertake transactions on his/her behalf, similar to a power of attorney (agency model)
Oman, Pakistan, Palestine, Philippines, Qatar, Russia, Saudi Arabia, Senegal, Singapore, South Africa, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, Trinidad & Tobago, United Arab Emirates, United Kingdom, United States and Yemen (Chong and Liu, 2007).

The present study is aimed at sharing knowledge on Islamic Banking by understanding principles of Islamic Banking; profit or loss paradigm; differences between conventional and Islamic banking; Shariah screening and ethical investment and relevance to Indian context.

**PRINCIPLES OF ISLAMIC BANKING**

The popularity of Islamic Banking stimulated the Western banks to adopt Islamic banking in two ways.

1. They included Shariah compliant products in the bank’s conventional products and services through special facilities called “Islamic windows” example: Abn-Amro, Citibank, and the German Dresdner Bank and
2. Opened ad hoc subsidiary divisions totally dedicated to Islamic finance- City Islamic Investment Corp. as an owned subsidiary division of Citigroup was created in 1996 (Ferro, 2005).

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shariah, known as *Fiqh al-Muamalat* (Islamic rules on transactions). The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of *riba* (usury). Common terms used in Islamic banking include profit sharing (*Mudharabah*), safekeeping (*Wadiah*), joint venture (*Musyarakah*), cost plus (*Murabahah*), and leasing (*Ijarah*).

The consensus of Islamic banking to that of conventional banking is only to the extent that banks are financial intermediaries mobilizing savings and channelising the resources towards productive investments. The difference between the two systems as quoted by Khan and Mirakhor (1992) and Dhumale and Sapcanin (2004) are

1. prohibition of charging or paying interest,
2. the impermissibility of demanding collateral and
3. to a small extent, compulsory charitable spending and
4. working on Profit or Loss paradigm

The thought of alternative to interest led to a novel development in many contracts entered by Islamic banks. They recognized four basic alternatives of financing to act as an alternative to interest like investment based, sale based, rent based and lease based (Dar, 2003).

**PROFIT OR LOSS SHARING (PLS) PARADIGM**

The major contracts structured on these lines are:-

*Musyarakah* contracts are similar to joint venture agreements, in which a bank and an entrepreneur jointly contribute capital and manage a business project. Any profit and loss from the project is shared in a predetermined manner. The joint venture is an independent legal entity, and the bank may terminate the joint venture gradually after a certain period or upon the fulfilment of a certain condition.

*Mudarabah* contracts are profit-sharing agreements, in which a bank provides the entire capital needed to finance a project, and the customer provides the expertise,
management and labour. The profits from the project are shared by both parties on a pre-agreed (fixed ratio) basis, but in the cases of losses, the total loss is borne by the bank.

The globalization of the economies has intertwined the existence of Islamic banks and Conventional banks. As is observed by Chong and Liu (2007) (a) changes in conventional deposit rates cause changes in Islamic investment rates, but not vice-versa, (b) the Islamic investment rates are positively related to conventional deposit rates in the long-term, and (c) when the Islamic investment rates deviate far above (below) the conventional deposit rates, they will adjust downwards (upwards) towards the long-term equilibrium level. This implies that the Islamic banking deposit PLS practices are actually closely pegged to the deposit rate setting practices of conventional banking.

Islamic contracting should not contain gharar (risk or uncertainty). But in reality any financial transactions contain risk and uncertainty. Even the PLS model has ex-ante fixed rate of return in financial contracting, which is prohibited, is replaced with a rate of return that is uncertain and determined ex-post on a profit-sharing basis. Only the profit-sharing ratio between the capital provider and the entrepreneur is determined ex-ante. This once again reiterates that Islamic contracts have risk and uncertainty attached. All Islamic Banks do not practice PLS arrangements entirely. Most of them offer trade and Project for a direct percentage gain. The revenues are also generated from overheads, customer short term funding and non interest earning assets (Bashir 1999). The reason for banks resorting to alternative earnings may be due to the fact that the deposits held by Islamic Banks are considered as shares thereby reducing the amount available for investment on the basis of PLS arrangement (Bashir, 2001 and Yudistara, 2003). It has been evidenced that banks can perform under the conventional banking architecture of having low PLS arrangements (Sarker,1999) but the lack of bankers’ understanding of financing under the PLS arrangement system (Samad and Hasan, 1999) has been another reason for many banks showing very less amount of business done under PLS arrangement. In some countries like Italy, Islamic Banking has not been successful as the Muslim population in the country are more concerned with remittances to their home country rather than indulge in investment activity making the viability of PLS arrangements very bleak (Ferro,2005). The success of this arrangement will depend upon how the financial institutions innovate products on basis of shariah and attract investors/clientele in a multicultural environment rather than in monocultures.

**DIFFERENCES IN CONVENTIONAL AND ISLAMIC BANKS**

Alkassim (2005) studied the profitability of Islamic Banks and conventional banks in Gulf Cooperation Council countries (GCC) by using the following ratios for the period-1997 to 2004

**TABLE 1: ASSET QUALITY RATIOS**

<table>
<thead>
<tr>
<th>Ratios (%) on Asset Quality</th>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Loss Reserve / Gross Loans</td>
<td>6.27</td>
<td>5.37</td>
</tr>
<tr>
<td>Loan Loss Provisions / Net Interest Revenue</td>
<td>9.59</td>
<td>13.55</td>
</tr>
<tr>
<td>Ratio</td>
<td>Islamic Banks</td>
<td>Conventional Banks</td>
</tr>
<tr>
<td>--------------------------------------------</td>
<td>---------------</td>
<td>--------------------</td>
</tr>
<tr>
<td>Loan Loss Reserve / Impaired Loans</td>
<td>81.75</td>
<td>97.44</td>
</tr>
<tr>
<td>Impaired Loans / Gross Loans</td>
<td>6.17</td>
<td>4.92</td>
</tr>
<tr>
<td>Net Charge Off / Average Gross Loans</td>
<td>0.25</td>
<td>0.19</td>
</tr>
<tr>
<td>Net Charge Off / Net Income Before Loan Loss Provision</td>
<td>6.75</td>
<td>4.01</td>
</tr>
</tbody>
</table>

Source: Alkassim, 2005

On comparison of asset quality ratios it has been established except the ratio on Loan Loss Provisions/ Net Interest Revenue which is favorable for Islamic banks, all the other ratios provide a view that the likelihood of the borrowers paying back loans is high for conventional banks in comparison with Islamic Banks.

On analysis of capital adequacy ratios it was evidenced that both the banking systems maintained ratio well above 8% (as prescribed by BASEL Norms) but Islamic banks were well capitalized in comparison with similar sized conventional banks.

On the operational front, Conventional banks in GCC countries have better operational ratios than Islamic banks. The Islamic banks excel conventional banks only in the following ratios: Return on Asset and Dividend Payout. Johnes et al. (2009) found that the Islamic banks of GCC countries for the study period 2004-2007 were revenue and profit efficient than conventional banks of that area. On the other hand they were not cost efficient (ibid). The reason is that Islamic banks are domestically owned, do not have a specific regulatory authority and are relatively smaller in size than conventional banks. Domestically owned Islamic banks face a problem of greater liquidity risk. The depositors expect a similar return like the conventional bank and this is complicated with the turn of events in the capital markets or banking policy (unpleasant policy for the investor) of a nation enhancing the necessity of the investor to withdraw funds and deposit it with the competitor i.e. conventional banks. Even banks of the countries having majority Muslim population (Indonesia) has faced liquidity risk due to the investor/depositor behaving rationally when the decision to invest huge sums for longer period is considered (Ismal and Wilson, 2008). The liquidity risk element also adds to problem faced by the Islamic Banks on the PLS front. As is established (Ismal and Wilson, 2008) that investor behaves rationally when it comes to investment decision it can be inferred that the depositor may not like to invest in equity funds and will lock up the funds in arrangements that guarantee a specific return for a certain period that is shorter than equity instruments. This inference is reiterated by the fact that almost all the Islamic banks have a minor share of PLS arrangements (Samad and Hasan, 1999; Bashir 1999; Sarker, 1999).
The liquidity risk is related to the profit rate distributed by Islamic banks to its depositors. Deviga and Ibrahim (2007) elaborate on the method of determination of profit rates by Islamic banks as follows:

In determining the rates of returns to depositors, the classes of accounts are categorized by types of accounts (institution need not have to pay any profit to the depositors of current accounts). Further, the general investment accounts are categorized by the pre-set periodical tenors of investment or in simpler term by the durations of periodical investment, which are in practice range from the period of one month to a period of sixty months or five years. The gross pool of profits created by utilizing the depositors’ funds shall then be determined on a daily basis. The total profits are then distributed amongst the various categories of deposits and investment by types of accounts and further by tenors of investment. The distribution of profit shall be computed by taking the daily weighted proportion of balances for each category of deposits or investment accounts as numerator and the total of all the daily or monthly weighted proportion of balances for all categories of deposits or investment accounts as denominator and be multiplied by the duly recognized daily profits created utilizing the funds of depositors and investors. Since, all categories of accounts by types and further by tenors of deposits and investment have already been apportioned with profits, each category’s profits shall now be shared according to the pre-agreed ratio, such as 30:70 between the institution and the depositors. Finally, the rates of returns are determined by taking the daily depositors’ profits for each types or tenors of deposits or investment as numerator and the actual average daily balance for each category of deposit or investment by types of accounts and further by types of tenors as denominators and be multiplied 100 and subsequently be annualized in obtaining the rates of returns for each class of deposit accounts which are used when making payment of profits to the individual depositors.

According to neo classical economists and contemporary economists it is believed that every customer aims at profit maximization. In finance, herd mentality proposes that the investor will follow the majority and hence will not be rational for...
long. If the environment in which an Islamic bank is operating is to be analyzed it can be found that a large number of Islamic Banks operate in a dual banking system. The conventional banks also recognize the differences in the account types, customer and deposit mix that can be built by offering different rates of interest. There is difference in the mean returns offered by conventional bank and Islamic Bank where the conventional banks and foreign banks offer a higher rate of interest (Deviga and Ibrahim, 2007). Since the investors exhibit a herd mentality they may shift their investments from Islamic bank to conventional bank in expectation of higher returns. Hence Islamic bank will have to raise their profit rates by increasing their PLS arrangements. The PLS arrangements can be converted into profitable contracts by close monitoring to reduce the effect of information asymmetry (Chong and Liu, 2007) existing in these types of contracts. The low content of PLS contracts in the financial statements of the Islamic banks indicate that competition has made the banks to modify their contracts for survival and therefore Islamic banking practices do not deviate substantially from a conventional bank.

An integration of the Shariah Compliance with modern business management models and practices will ensure a success in reducing liquidity risk and will mobilize the resources to PLS arrangement for the bank and increase profitability and reduce interest rate exposure for the investor/depositor. There have been positive developments in the products offered by Islamic Banks like (i) the National Participation Paper, (ii) the Central Bank Musharakah Certificate, and (iii) the Government Mudharaba Certificate (Sundararajan et.al.,2007) to resolve intractable problem of low PLS arrangements affecting Islamic banking. The adoption of Islamic banking has not collapsed the financial system of a nation in fact it has raised deposits from private sector under Islamic modes (Khan and Mirakhor, 1989). The PLS arrangements has not affected the growth of Islamic banking. Many organizations are working to bring uniformity to ensure that Islamic banking is sustainable in the long term. Some of the organizations are 1. The National Sharia Board of Malaysia; 2. The Accounting and Auditing Organisation for Islamic Financial Institutions; 3. Islamic Financial Services Board; 4. Islamic Fiqh Academy. The growth of Islamic banking is attributed to the fact it operates on the basis of a principle propounded by Islam- i.e. favors equitable distribution of wealth through collective participation in production. This is the need of the hour in many emerging economies. The conventional banking system was affected by the recent financial crisis as it was highly levered; had speculative transactions to make higher profits and as a result purpose orientation of the banks was lost in greed to make more profits. The principle of Islamic banking has increases the awareness for ethical investment among investors. The global market realized the importance and developed indices for screening ethical investments.

**SHARIAH BASED SCREENING AND ETHICAL INVESTMENT**

The screenings of investments are done based on the shariah compliance for investments to be made as per Islamic Finance. There are indices for shariah compliant investments as per the report published by Standard & Poor’s (2007) give the following information:

**S&P 500:** Widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. **S&P Europe 350:** The S&P Europe 350 combines the benefits of representation with investability for the Europe region, spanning 17 exchanges.
S&P Japan 500: Introduced in 2002, the S&P Japan 500 is designed to represent the Japanese investable market. Index constituents are drawn from eligible companies listed on the Tokyo, Osaka or JASDAQ exchanges.

S&P GCC: The Gulf Cooperation Council (GCC) is an organization of six Arab states that share many social and economic objectives. These states are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirate (UAE). Standard & Poor's Emerging Markets Data Base (EMDB) indices were the first to focus on this region. The Indices include six Shariah-compliant country indices, a composite S&P/IFC GCC Shariah Index, which excludes Saudi Arabia, and a composite S&P/IFCG GCC Shariah Index, which includes Saudi Arabia.

S&P Pan Asia Shariah: The stocks for this index are drawn from the Asian country indices in the S&P Citigroup Global Equity Index series, excluding Australia, Japan and New Zealand. Stocks for the universe must have at least US$ 1 billion in float-adjusted market capitalization. The number of stocks, for Shariah screening purposes, is limited to the top 15 from each country which exceeds the US$ 1 billion market capitalization threshold. Each month a universe of stocks conforming to these criteria selected once a year on March 31st, is screened for Shariah compliance to form this index. The countries eligible for inclusion in this index are China, Hong Kong, India, Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand.

The concept of shariah compliance is to enable redistribution of wealth and promote social well being in the society. There is a closeness of this thought to that of the concept of Socially Responsible Investing. Here too the investments are screened on a similar basis. As stated in Basso and Funnari (2007) the screening of investments are done by institutions by adoption of a strategy called the positive screening where issues such as: 1. products beneficial for the environment and quality of life; 2. customers, product safety, advertisement competition; 3. environmental services and technologies; 4. environmental policies, reports, management systems; 5. environmental performances; 6. employees policies, reports, management systems; 7. employees performances; 8. suppliers and measures to avoid human rights violations; 9. communities and bribery; 10. corporate governance are evaluated to arrive at an ethical measure to help in decision making. The negative screening can also be done by scrutinizing issues such as Negative screening issues: 1. Firearms; 2. weapons and military contracting; 3. nuclear energy; 4. tobacco; 5. gambling; 6. human rights and ELO fundamental conventions violations; 7. child labour; 8. oppressive regimes; 9. pornography; 10. alcohol; 11. animal testing; and others.

“Socially Responsible Investing (SRI) is an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis. It is a process of identifying and investing in companies that meet certain standards of Corporate Social Responsibility (CSR)” (SIF [2003] p.3)

It is only recently India has launched the ESG Index. SRI is based on ESG (Environmental, Social and Governance) Standards. Standard & Poor's, Crisil, and KLD Research & Analytics (the social and environmental research firm), early in 2008 together announced the launch of the S&P ESG India Index -the first index of companies whose business strategies and performance demonstrate a high level of commitment to meeting ESG standards. Initiated and sponsored by the International Finance Corporation (IFC), a member of the World Bank group, this index comprises 50 Indian companies that meet certain ESG criteria and have been drawn from the
largest of the 500 companies listed on the National Stock Exchange of India, through a two-stage screening process. The ultimate objectives of

- Redistribution of wealth among various stakeholders
- Adapting and innovating the moral ethos from various cultural backgrounds for profitability of the organization
- Achieving sustainability, development and competitive edge

It can be attained by integrating economy and culture as is the case/fact in Islamic Banking or Socially Responsible Investing (SRI). Both are exploring the potential and untapped market that will enable them to positively catapult their growth rates as well as the economy. The traditional system no longer suits their requirements and hence they have shifted to a sustainable system. The transition of balance sheets from traditional to sustainable system has been achieved by recognizing the contribution of Human Capital and Entrepreneurship reflected in the form of tangible and intangible assets (Cornell and Shapiro, 1987). The sustainability is achieved by multi optimization of profit, people and planet on the basis of cooperation and trust of a portfolio of stakeholders with an ethical approach towards investment decision making (Soppe, 2008). Islamic Banking and socially responsible investing are in fact a refinement of traditional financing and investment model respectively.

**RELEVANCE TO THE INDIAN CONTEXT**

India is a developing country requiring equitable distribution of income and wealth; poverty alleviation and uplifting the entrepreneurial talent present in abundance. The opening of gates for Islamic banking in a way would ensure responsible participation (encourages partnerships of entrepreneurs with the bank) of the citizens in investment activity as the concept of Islamic banking is based on equity participation in various companies with a profit or loss arrangement which would in turn positively influence economic development. Islamic banking can tap the resources of Indians practicing shariah i.e. who do not keep balances in the conventional banks and instead lock their funds in real estate and gold. Greater FDI into India from the Gulf region, which has around $3-4 trillion disposable revenues, can be channelised through Islamic banking for infrastructural development which would be 1. beneficial for the banks as they need contracts for enhancing profitability (as the contracts would be based on PLS arrangements) and 2. would benefit the customer as the contract is shariah compliant. In principle a part of the earning is given in the form of charity (Zakah) to the poor by the Islamic banks. If the term Islamic banking seems too communal the principle of this banking model can be termed differently as ‘participatory banking’ (Alam, 2010). At present Indian Banking System is interest based and would require separate legislation for introduction of this model of Banking in India (Subbarao, 2010). If done then India which has marginal farmers, SMEs, unorganized sector enterprises, self employed individuals and others who barely can sustain would receive financial assistance free of cost but with added responsibility of earning profits as the losses also would be borne by them (Raqeeb, 2010).
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