

**Islamic Finance - Bank Lending**

**A Dilemma & A Challenge**

**1. Introduction**

It is a core tenet of Sharia (Islamic Religious Law) that the charging of interest without undertaking risk is forbidden.

Even though this tenet raises issues, there are considerable opportunities for Western banks to become involved in Sharia compliant finance or Islamic finance. Whether engaging in transactions with individuals, companies and businesses within Islamic countries or within the sizeable Islamic minority communities in many of the developed states, banks and financial institutions have an opportunity to attract significant deposits to fund their capital and liquidity regulatory requirements and also to add significantly to their profits by engaging in lending which is in accordance with Sharia principles.

Rahail Ali and Mustafa Kamal <sup>1</sup> have stated that the Islamic Finance Industry is estimated to be of a value in excess of USD \$1.3 trillion and to be growing at approximately 15% a year. Clearly there are opportunities for banks when such an amount of funds is involved.

In this paper, I propose concentrating on one aspect of Islamic finance and that is bank lending.

**2. The Historical Perspective**

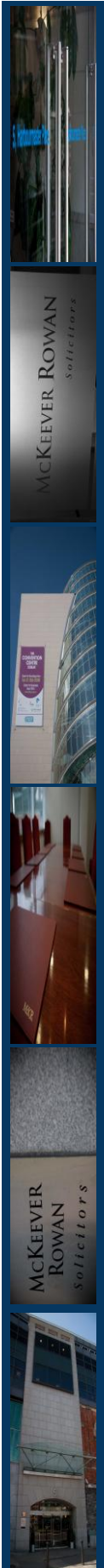
From ancient times the charging of interest on money loaned or usury was viewed with disfavour.

- (i) Aristotle, in his Politics and Ethics, 350 BC, disapproves strongly of usury.

*“There are two sorts of wealth getting, as I have said one is part of household management, and the other is retail trade. The former necessary and honourable, while that which consists in exchange is justly censured; for it is unnatural and a mode by which men gain from one another. The hated sort, and with the greatest reason is usury, which makes a gain out of money itself and not from the natural object of it. For money was intended to be used in exchange but not to increase at interest and this term interest which means the birth of money from money is applied to the breeding of money because the offspring*

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<sup>1</sup> Business Law International (Volume 10 No. 1 January 2009)



*resembles the parent. Wherefore of all modes of getting wealth this is the most unnatural*.<sup>2</sup>

*“Others again exceed in respect of taking by taking anything and from any source, e.g. those people, and these who lend small sums at high rates. For all those take more than they ought and from the wrong sources”*.<sup>3</sup>

- (ii) In the Judeo Christian tradition similarly there was disapproval of usury. In the Old Testament there were references which have been interpreted as disapproving of usury.

*“If thou lend money to any of my people that is poor by thee, thou shalt not be to him as an usurer, neither shalt thou lay upon him usury”* - Exodus 22:25

*“[He that] putteth not out his money to usury, nor taketh reward against the innocent. He that doeth these shall never be moved”* - Psalm 15:5

*“He that by usury and unjust gain increaseth his substance, he shall gather it for him that will pity the poor”* - Proverbs 28:8

*“[That] hath taken off his hand from the poor, [that] hath not received usury nor increase, hath executed my judgments, hath walked in my statutes; he shall not die for the iniquity of his father, he shall surely live”* – Ezekiel 18:17

*“In thee have they taken gifts to shed blood; thou hast taken usury and increase, and thou has greedily gained of neighbours by extortion, and hast forgotten me, saith the Lord GOD”* – Exekiel 22:12.

- (iii) Of course, the Islamic faith derived much of its thinking from the earlier Judeo Christian tradition and in the Qur’an, usury (riba) is disapproved of.

*“Those who feed themselves on usury (riba) behave but as he might behave whom Satan has confounded with his touch for; for they say, “buying and selling is but a kind of usury” – the while God has made buying and selling lawful and usury unlawful hence, whoever becomes aware of his Sustainers Admonition, and thereupon desists may keep his past gains, and it will be for God to judge him; but as for those who returned to it – they are*

<sup>2</sup> The Politics, 1258b, translated by Benjamin Jowett, Oxford Clarendon Press 1921

<sup>3</sup> Ethica Nicomachea Book IV. 1 – 1122a, translated by W. D. Ross MA Oxford University Press 1915

*destined for the fire therein to abide!" AL –  
BAQARA. 2:275*

- (iv) Initially the Romans forbade usury but in later times, the Romans permitted the charging of interest on loans but fixed maximum rates. Indeed in the 16<sup>th</sup> Century Christianity permitted the charging of interest but like the Romans, they limited the amount of interest which could be charged and the term "usury" then came to imply an excessive charge of interest rather than the charging of interest. However, it would appear in the Islamic tradition and Islamic jurisprudence that the charging of interest is forbidden and that the original meaning of usury or riba is applied.

### 3. The Need for Credit

Societies improve their material wellbeing and for many their emotional wellbeing through a process of economic growth.

The primary driving forces of economic growth are entrepreneurs whether in the private sector or the State itself either directly or indirectly through its agencies. In an increasing competitive world and trade contributed to by the agreements of the World Trade Organisation and particularly the General Agreements on Trade and Tariffs, size and scale are important to achieve economies and compete.

In the private sector, whilst it is theoretically possible to grow scale by reinvestment of profits and surpluses, the time period to achieve scale is likely to be very long and in consequence, economic growth is going to be much slower. However where credit is available, a proposed enterprise that is well thought out is likely to achieve size and scale allowing it to compete and trade internationally with more success. The consequence of this is economic growth and benefit to society.

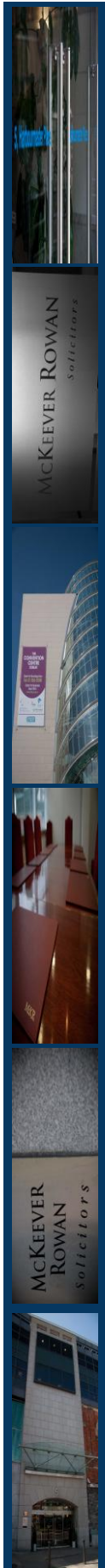
To a lesser extent, State enterprise has a need for credit. Whilst the resources of the State can be used in such enterprises where there are competing uses for such resources as in the case of all modern states, credit has a role to play.

So if less developed countries are to grow and prosper at a reasonable pace, it is important that credit is available and that there are no ethical or religious barriers to such.

This also applies to groups within societies in the developing world living within the ethical and religious code and principles of Islam.

### 4. The Principles underlying Islamic Finance and Lending

The basic principle of Sharia in relation to commercial matters is fairness between the parties. From this is derived the principle that charging interest without any assumption of risk is forbidden. Hence the structures in the Qur'an an example of which I have given above and in other Islamic teachings.



There are other issues under Sharia which apply such as the investment in Sharia compliant enterprises. However in a short paper such as this I do not intend except by slight reference to deal with these. I am concentrating on the core central relationship between a bank and the customer it is funding.

**5. The Banks' Dilemma**

Banks operating in modern states obtain funds from shareholders, from deposits from customers and from in turn, borrowing in the market such as the LIBOR or EURIBOR markets. For the purposes of ensuring their solvency, banks are subject to regulatory control to maintain adequate capital ratios and liquidity ratios. They therefore have a duty and an obligation to manage carefully their lending and to be prudent so as not to put at risk funds entrusted to them and to obtain a reasonable return.

Therein is the dilemma. If a bank is not permitted over a wide range of transactions to charge interest or cannot be reasonably assured of a return on monies lent without incurring more risk than conventionally arises, then it puts its funds at risk and it fails in its duty to those from whom it has acquired its funds and is further at risk of breaching its regulatory obligations.

**6. The Challenge**

The challenge is to meet the requirements of Sharia regarding the non charging of interest and the requirement of some element of risk while at the same time protecting depositors', shareholders' and borrowed funds and achieving a return on these funds.

To see how this can be done it is useful first to examine the process of traditional bank lending.

**7. Traditional Lending**

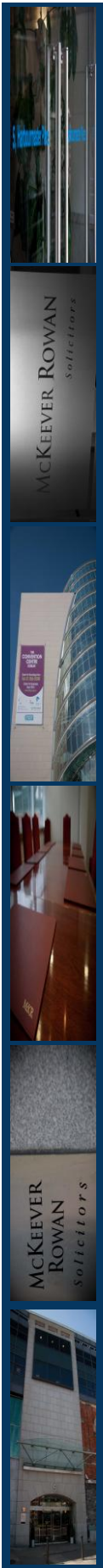
There are various elements or stages in the lending process in which banks engage which might be generally described under the following headings:-

(i) The customer assessment.

A bank will investigate and enquire into the honesty and probity of a customer and his or its net worth with a view to establishing the ability in certain circumstances of the customer to repay loaned funds.

(ii) The enterprise assessment.

A bank will have regard to the purpose to which the funds are to be applied. If it is not intended that the loan is to be used for consumption purposes but to be invested in an enterprise or property which is to generate a return out of which the loan and interest will be partially or completely repaid; in this latter situation the bank will engage in certain level of due diligence and seek business plans and projections.



(iii) The loan agreement and terms.

This letter or document which will be signed by the customer will set out the special terms of the loan and in addition apply the banks general terms and conditions to the loan agreement.

The terms will include specifying the amount of loan, the term period over which repayment and the instalments by which, the loan will be repaid; the rate of interest applying; circumstances of default whereby the loan will be liable to be paid back earlier and the security or collateral which the bank will require.

(iv) Security or collateral.

Except in respect of modest amounts the bank will require that the borrower and/or a guarantor will mortgage or charge assets to secure the amount of the loan. Sometimes inter-company guarantees or directors/shareholders guarantees or third party guarantees will be sought.

(v) Provisions for default.

In certain circumstances the loan will be required to be repaid in full before the end of its term. Typical default provisions are

- Where the repayment instalments are in arrears.
- Procedures are commenced for the winding up of a company or the declaration of bankruptcy in respect of an individual.
- The bank is of the view that the circumstances exist which put the repayment of the loan and the security at risk.

In such circumstances, a bank may take action to realise its security by appointing a receiver or similar officer or by seeking a well-charging order and a Court order for sale of the assets forming the security out of which proceeds the Bank would hope to be paid.

Of the five elements of traditional bank lending the first, the customer assessment and to a certain extent the second, the enterprise assessment is likely to be shared with Sharia compliant funding procedures. However, with regard to the third element, the loan agreement, while in Islamic finance an agreement related to the nature of the transaction will be required, an agreement simply charging interest without an assumption of risk will not be acceptable. Similarly, it would be difficult to accept element three, security and collateral, that is that if there is default that a bank could realise the security and out of the proceeds of same recoup the loan and interest. Also the element, four, providing for default in

circumstances which may be outside the control of the enterprise being funded is also likely to raise difficulties.

Also, an issue for banks will be the need to obtain approval for types of transactions directly or indirectly from religious and Sharia jurisprudence experts.

**8. The Answer**

A certain amount of work has already been done to facilitate what is in effect Sharia compliant bank lending but may be called something else. This has been helped by the existence of international bodies such as the Islamic Financial Services Board (“IFSB”)<sup>4</sup> which has drawn up draft guiding principles on the conduct of business for institutions offering Islamic Financial Services and is also engaged in developing prudential standards. The IFSB has approximately 200 members of various classes including the World Bank.

Many banks in the Middle-East and in other Islamic countries are providing Islamic finance.

One method of complying with Sharia is to shape an otherwise lending transaction in the form of a mudarabah contract. Such a contract is described in the draft guiding principles of the IFSB as follows:

*“A contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is be managed by the entrepreneur as the Mudarib (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the Mudarabah agreement, while losses are to be borne solely by the capital provider unless they are due to the Mudarib’s misconduct, negligence or breach of contracted terms”*

It will be immediately apparent that a contract in this form will not appeal to conventional banks as effectively a large element of risk is carried by the lender.

Another method where an asset is being acquired is to engage in a murabaha contract. This is described by Mustafa Hussain<sup>5</sup> as follows:

*“Under a murabaha arrangement, the investor would identify the assets for sale and then negotiate a purchase price with the seller. The investor would then approach the financier with the proposed terms of the asset sale and request finance in a Sharia-compliant manner. The investor, acting as undisclosed agent of the financier, would then usually contact seller to acquire the asset from him at the agreed price on behalf of the financier. The financier would pay the seller the purchase price and would acquire legal title to the asset. So far, the first contract for sale has been executed. The asset has passed from the seller to the*

<sup>4</sup> [www.ifsb.org](http://www.ifsb.org)

<sup>5</sup> Islamic Finance, Global Business Publishing Limited 2008

*financier and the funds for the purchase price have passed to the seller from the financier. The purpose of the second contract is to transfer the title to the asset to the investor and for the investor to pay the financier the cost price, plus profit.”*

This is a better arrangement from a bank’s point of view in that it has control over the asset acquired but may not be attractive to banks as ownership of the asset remains with the bank and with ownership comes duties and liabilities.

Another method described by Mustafa Hussain<sup>6</sup> is the use of the ijara or lease:

*“In its basic form, the lease contract used in Islamic finance is not dissimilar to those seen in non Shariah-compliant transactions. The parties to the contract are a lessee and a lessor. The terms of the lease can be for any specified period. Hire-purchase combinations are often used and a good example is the real-estate finance lease used by a number of international banks in the retail sector for Shariah-compliant home acquisitions. For example, a customer finds a home he wishes to acquire. He agrees a price with the seller. The customer applies to the bank for Shariah-compliant finance. The bank acquires the property for the purchase price from the seller and the bank retains title to the property. The bank then enters into a lease with its customer. The bank acts as landlord and the customer is tenant. The landlord leases the property to the tenant in return for payments at regular intervals. The payments comprise:*

- *A portion of rent, which is payment by the tenant to the landlord for use of the property; and*
- *A portion of repayment towards the purchase price for the property.*

*At the end of the contract period, the customer would have repaid the purchase price to the bank, plus an extra profit element and the bank would then transfer property title to the customer. The bank can permissibly retain the profit because it has assumed the risk in the property and allowed the customer all of the benefit of using the property.”*

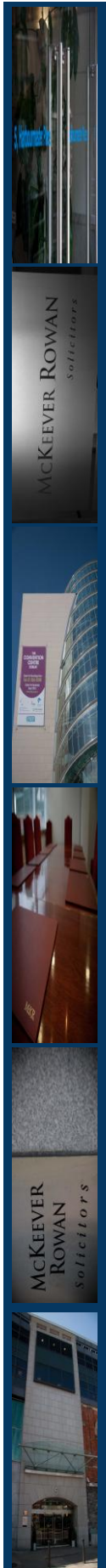
While this has advantages for a bank again it leaves ownership with the bank and as a landlord. If as in the example it is applied to a residential property other issues arise. Domestic legislation in many jurisdictions place onerous responsibilities on landlords and in some cases determine the rent which can be charged. This may not appeal to many banks.

So there is further work needed to be done.

## 9. Conclusion

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<sup>6</sup> Ibid



In all this the real challenge is to develop structures, forms of agreements and precedent documentation that closes the gap between the perceived requirements and lending practices of Western banking and requirements of Sharia. This must be an ongoing work which will require creative skill with the development of acceptable documentation.

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