Cash Loans under Islamic Financial System: A Workable Solution

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Abstract

Islamic Banking has shown tremendous growth in first decade of twenty first century. In order to avoid interest charging Islamic banks transect business through sale/purchase (Murabaha, Muajjal, Salam, Istisna'a), Leasing (Ijara) and profit and loss sharing (Musharaka, Mudaraba, PTC, TFC, Skuk). Cash loan facility is not available in present framework of Islamic banking. This article has elaborated five options including Time Multiple Counter Loans (TMLC), Normal Rate of Return (NRR), Inflation Based Loan Indexation (IBLI), Overhead charges on loans and educational loans to present a workable solution for cash financing by Islamic banks.

Key Words: TMLC, Islamic banking, Cash financing, Commercial loans, Qarz e Hasna, Loan indexation, Educational loans

GEL Classification: G 21, Z 12

1-Introduction

First decade of twenty first century witnessed an unprecedented growth and expansion of Islamic financial system world over in spite of crisis in world leading economies. Global Volume of assets under Islamic financial system has cross the figure of one trillion- US $ 1,041 Billion by the end of December 2009 (IFSL-2011). Middle East is the centre of Islamic finance with global share of about 80% followed by South and Far East Asia 15%. In Pakistan Islamic banking has grown and expanded at an average annual rate of 71% in the last seven and half years -01/04 to 06/11- (Hanif, 2011).

Islamic financial system is based on *Shari'a* (Islamic law) whereby interest charging in a loan transaction is *Haram* (unlawful). In order to adhere this Shari'a constraint Islamic Financial Institutions (IFIs) do not provide finance in cash for a charge rather transect business by using trading, rental and equity based modes of financing. Trading and rental modes of financing are used excessively by IFIs in provision of financing as compared to equity financing due to lesser/zero uncertainty about the outcome of investment, however deposit collection is fully based on equity modes of financing. Generally Islamic banks provide financing through *Murabaha* (deferred sale of a commodity on profit), *Salam* (spot payment with deferred delivery of subject matter), *Istisna'a* (order to manufacture a product, payment may or may not made on spot), *Ijara* (leasing or renting an asset for use ending in transfer of ownership), *Musharaka* (participation in profit and loss of a project or a business for a particular period), *Diminishing Musharaka* (a mortgage transaction whereby stake of bank decreases and that of customer increases over the period ending in transfer of ownership to customer) and *Mudaraba* (partnership of skill and capital)[1]. Three of the modes are based on sale/purchase of an asset, one on renting an asset, two on partnership and one is mixture of partnership and leasing. Any customer who needs bank loan for any of its need can opt one or other mode of financing to transect business with Islamic banks. Deposits are collected under any of three schemes including current (free of charge loan), *Musharaka* and *Mudaraba*.

There are certain customer needs including payment of operating expenses, an urgent payment to a vendor, long distance travels and tours, children education, marriage expenses, health expenses and credit card facility etc. which cannot be fulfilled through any of above listed

[1] For detail understanding and working of these financing modes please see "Islamic Banking: Financial Reporting Perspective" available at Amazon.com

modes of financing, hence require cash loans. However in present practice of Islamic banks one cannot get loan in cash except Qarz e Hasna (charity loan). Qarz e Hasna is not a business model in itself. Islamic banks are not charitable institutions rather commercial houses. In fact Islamic banks or any other business can survive only through earning profit which does not exists in transaction of Qarz e Hasna. It is appreciable that Islamic banks must reserve a certain amount for Qarz e Hasna; however that can only be done in a prosperous Islamic bank.

Rest of study proceeds in following order. In section two options available with IFIs are discussed while section three concludes.

2- Cash Loan Options

In following paragraphs certain frameworks for provision of interest free loans (not Qarz e Hasna) is elaborated.

2.1. Time Multiple Counter Loans

Time Multiple Counter Loan (TMCL) is a concept suggested by Council of Islamic Ideology (CII), Pakistan in its first report on "elimination of Riba from the economy" in 1980. As per this concept a needy customer can get cash loan without paying any interest from bank, however a small amount of counter loan/deposit (free of charge) for a longer period is to be provided to bank. Under this mode of financing a larger amount of cash loan with shorter maturity issued by bank is compensated through a smaller amount of loan/deposit for a larger period by customer. Bank can earn higher rate of profit by investing this shorter amount of cash in a long term project. Following example would make concept clear.

A person needs an amount of loan in cash amounting to Rs; 500,000 for three months and request to financier by offering Rs; 50,000 for longer period which equate the daily product of both loans. Daily product of Rs; 500,000 for three months become Rs; 45,000,000 (500,000*90). In order to equate daily product of both amounts, deposit (loan) by customer must remain in bank for a period of 900 days or 2 years and six months (45,000,000/50,000). If a customer negotiates loan with bank amounting to Rs; 500,000 payable after three months and open fixed deposit account amounting to Rs; 50,000 for 2 years and six months transaction can be carried out. For bank incentive is very high. Let us assume KIBOR of 10% and further assume expected return on a long term project is 15%. Return on Rs 500,000 for three months become 12,500 while return on long term market based investment is Rs 18,750.

Let us see this practice in totality and form a hypothetical portfolio of assets and liabilities of an Islamic bank. Following is hypothetical balance sheet (table 1) of an Islamic bank on year zero.

Table-1. Balance Sheet

Liabilities	**Amount**	**Assets**	**Amount**
Equity	1,000,000,000	Cash	5,500,000,000
Deposits	5,000,000,000	Other Assets	500,000,000
Total	**6,000,000,000**	**Total**	**6,000,000,000**

Assuming 10% of deposits submitted to SBP. Cash left with bank amounting to Rs 5,000,000,000. Further assume 20% of deposits is used for TMCL at 25% rate. It means bank has lent interest free loans amounting to Rs 1 Billion for one year for an interest free deposit of Rs; 250 million for 4 years. Out of this 10% further is to be deposited with SBP (cost of conversion of short term deposit in long term). An infrastructure project of four years with Rs; 225 million costs is at hand with market price of Rs; 450 at completion. Bank will earn equal to Rs; 225 millions in four years (22.5% per annum on deposit of Rs; 250 million) and accrued profit of Rs 56.25 million in first year.

Table-2. Analytical table of Time Multiple Counter Loan for five years (Rs in millions)

Deposit	**Interest free loan**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
250	1,000	56.25	56.25	56.25	56.25				
250	1,000		56.25	56.25	56.25	56.25			
250	1,000			56.25	56.25	56.25	56.25		
250	1,000				56.25	56.25	56.25	56.25	
250	1,000					56.25	56.25	56.25	56.25
Total profit (Yearly)		**56.25**	**112.50**	**168.75**	**225.00**	**225.00**	**168.75**	**112.50**	**56.25**
Total profit (5 & 8 years)						**787.50**			**337.50**

Let us assume the first year circumstances repeated for next five years. Realized (accrued) profit in five years is amounting to Rs 787.5 million which is 16% per annum and till completion of tenure Rs; 1,125 millions (787.5+337.5) which is 22.5%. Detailed working is presented in following analytical table (Table-2).

After making payment of 10% of deposits to SBP and lending 1 billion under TMCL bank left with cash of Rs; 4.225 billion (5.5-1-.5+.225) which can be invested prudently in Murabaha, Ijara, Salam, Istisna'a and diminishing Musharaka. Let us further assume bank invested in following ratio (table-3). After one year following would be earning and financial position. Interest free loan amounting to 1 billion returned. First installment (25%) of selling price Rs; 112.5 million received. Receivables of Murabaha amounting to Rs 1,400 million received. Marketable securities realized amounting to Rs; 1,500 millions. First installment of diminishing Musharaka received amounting to 192 million (80+112). First year Ijara received amounting to Rs; 80 millions. It all accumulated cash balance to a figure of 4,784.5 million (500+1000+112.5+1400+1500+192+80). Earnings of the bank amounts to Rs; 600 million approximately, (56.5+150+ 250+112+30). If we reserve 10% for variations still Rs; 540 million is earnings.

Table-3 Investment Portfolio

Description	**Rs in Millions**
cash in hand	500
Reserve with SBP	525
Interest free loan	1,000
25% Infrastructure (4 years)	225
Marketable Securities (18% average return)	1,250
12% Murabaha one year	1,250
14% Diminishing Musharaka 10 years	800
15% Ijara 4 years	200
Other assets	500
Total	**6,250**

Assuming 8% deposit service which becomes Rs; 320 million (4,000,000,000 *8%, assuming average deposit for a year) and left with bank is Rs; 120 million to meet the cost and earn residual as income. If 60 millions is cost then 60 million is net earnings for bank which is

6% of equity, however profit of Rs 168.5 million (225-56.5) shall be received in next three years without any investment. If we include that amount then it becomes 228.5 million which is 23% approximately.

2.2. Normal Rate of Return

Financing based on normal rate of return (NRR) was also suggested by CII in its report in 1980. According to this mode of financing cash loans should be provided to entrepreneurs based on a normal rate of return as determined by an independent specialized agency. Any excess earning than normal rate of return should also be shared with IFI by entrepreneur voluntarily. It will provide an assurance to IFI about the minimum return. However in case of lesser actual profit than normal rate of return or loss, entrepreneur will have to prove the same to the satisfaction of the independent specialized agency who determined the normal rate. Upon satisfaction of the third party bank will accept lesser profit and/or share loss as the case may be.

NRR is to be decided for each sector based on overall economic situation in the economy by an independent specialized agency (like central bank or rating agencies). NRR may not be equal for all sectors of the economy like interbank offered rate (IBOR) of interest. In fact mechanism working behind the two rates (NRR, IBOR) is different. IBOR is determined based on demand and supply of capital, while NRR is determined based on economic outlook of a sector of the economy e.g. housing, textile etc. This scheme has the potential to reduce chances of fraud as well as concealment of actual outcome by an entrepreneur as equity based financing is discouraged due to lack of trust and transparency. This scheme is also very helpful in financing cottage industry and small businesses where establishment of accounting system and auditing is not feasible due to cost reasons.

CII has further shown its concern about the possibility of misapplication of NRR in all banking transactions leading to opening backdoor for interest hence suggested careful use of NRR and practically restricted to financing operations of small scale businesses as well as continuous monitoring and updating of rate by independent specialized agency entrusted with the job.

2.3. Inflation Based Loan Indexation

In current regime of paper currency inflation reduces the purchasing power of currency resulting in loss of wealth. In certain countries (including Muslim countries) double digit inflation has made the lives of masses miserable. Certainly wealth kept in currency is lost by its owner. As Interest free loans carry no return for provider of capital and original amount is returned, consequently wealth of loan giver is lost due to inflation. It is a serious problem in prevailing Islamic financial system working in paper currency regime having built in inflation.

As per objectives of Shari'a protection of faith (Eeman), life (Jaan), wealth (Maal), next generation (Nasal), liberty (Aqal) and honor (Izzat) of citizens should be guaranteed by Islamic society. It is the duty of the government to protect wealth, faith, honor, life, liberty and children of the citizens. Protection provided by governments to their citizens in Muslim world varies from country to country and from class to class within a country. An analysis of protections available to citizens in Muslim world is beyond the scope of this study; hence I am restricted to the topic.

Inflation is caused due to gap in demand and supply of a commodity. It is the duty of regulator to ensure uninterrupted demand and supply of commodities. Hoarding, gambling, storage, futures, forwards, mixing, cartels, monopoly etc are the factors interrupt supply and must be checked through enforcement of law. Inflation is also caused due to deficit financing and financial indiscipline by the government. In some of Muslim societies both causes of undue inflation prevail resulting in suffering of citizens and needed to be addressed. Even after addressing undue inflation mild inflation shall prevail under paper currency regime resulting in loss of wealth. In order to ensure capital maintenance indexation of loans based on increase/decrease in general price level is justified and Islamic Fiq Academy (IFA), Jeddah should look into the pending matter.

There are several inflation indicators in an economy including consumer price index (CPI), wholesale price index (WPI), sensitive price index (SPI), oil price index (OPI), exchange rate price index (EPI) and sectorial price indexes etc. Which of the inflation indexes is appropriate for a loan transaction indexing under Islamic financial system? Answer would be different for different economies and a specialized public agency should be entrusted with the job to decide. An appropriate proxy for inflation could be gold price, a basket of commodities as well as a basket of currencies. Again inflation charge may not be termed as rental of money as it is required to maintain the purchasing power of the currency. If indexation gets approval from

Shari'a experts then it could be used in personal loans, credit card transactions and working capital requirements of businesses where any of the existing modes of IFIs (trading, sharing, rental based) could not be applied.

2.4. Overhead Charge on Loan

At present IFIs are working as institutions and spend millions of rupees as overhead. A charge for overhead expenses estimated reliably could be justified in a loan transaction of cash. It could be in the form of fixed fee on issue of credit card with a certain limit to customer in order to facilitate, although debit card of IFIs have successfully replaced the need of credit card as for use of card is concerned, however credit needs can be fulfilled by charging overhead expenses. Practically these charges would be a very small fraction of total loan amount and ceiling should be fixed by central bank.

2.5. Educational Loan

IFIs should develop a scheme of merit based educational loans for needy students out of current deposits. Furthermore IFIs can motivate some of its customers through a scheme of no return deposits from customers interested in helping needy students. Late payment charges form a reasonable amount with IFIs which are used as charity, could also be used for educational loans.

The above schemes carry certain merits for Islamic financial system in practice including following:-

1. Provision of cash loan facility to customers which does not exist in present framework. It is important to have built in cash loan facility to customers otherwise this system would not be able to meet entire financing needs of an economy hence, failure in replacing the conventional financial system.
2. It facilitates provision of cash loans for commercial purposes and reduces the only option of Qarz e Hasna under Islamic financial system which is not a business model rather a charity and Islamic banks are not charitable institutions rather they are commercial houses and can survive only through earning profit.
3. It helps in meeting the needs of customers which cannot be fulfilled through any of prevailing financing mode.

4. It will open doors for credit card facility to customers which has become prime need keeping in view the facilities attached to it.
5. It will boost the limited access of Islamic banks to a larger community desiring finance in hard cash form.
6. It will make Islamic banks competitive to their conventional counterparts.
7. It will help Islamic banks to finance government needs of funding, consequently Islamic financial industry will get support from regulators as well as it will serve as a motivational tool to enhance political will of Muslim countries' governments to replace the conventional banking with Islamic banking.
8. It will assist in promotion of research and education vital for uplift of Muslim socities.

3- Conclusion

Islamic Banking has shown tremendous growth in last ten years in global as well as in local market. It is result of a dream to replace conventional banking based on interest prohibited in all known revealed religions including Judaism, Christianity and Islam. In order to avoid interest charging Islamic banks transect business through sale/purchase (Murabaha, Muajjal, Salam, Istisna'a), Leasing (Ijara) and profit and loss sharing (Musharaka, Mudaraba, PTC, TFC, Skuk). Cash loan facility is not available in present framework of Islamic banking. This article has elaborated five options including Time Multiple Counter Loans (TMLC), Normal Rate of Return (NRR), Inflation Based Loan Indexation (IBLI), Overhead charges on loans and educational loans to present a workable solution for cash financing by Islamic banks.

Although these cash loans modes of financing are feasible in operations of IFIs [subject to approval of IFA, Jeddah, and Shari'a Board of practicing IFIs] but should be used in special circumstances where none of trading, rental and equity based modes of financing is applicable and should not be misapplied to open back door for interest. Cash loan facility is essential to cater for total needs of an economy if Islamic financial system is aimed at replacing and complete elimination of interest based conventional banking from an economy. Application of cash loan financing will help in meeting financial needs of working capital of firms, cash needs of nonprofit organizations, personal cash needs of individuals for education, travel, health and social ceremonies. It is expected that issue of cash loans shall receive due consideration from Shari'a experts, IFA- Jeddah, regulators, Standard setting bodies and Shari'a boards of IFIs.

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