Incentive Compatible Contracts: The Islamic View

(A Discussion Paper)

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Abstract

The twentieth century has witnessed resurgence in the observance of fundamental Islamic practices around the world. The Islaimization of the financial sectors of many Muslims countries was a natural consequence of this resurgence, and the degree of Islamization varied dramatically across countries with Muslims populations. The Islamic Republic of Iran and Pakistan are at one extreme, where the entire financial sector has been made officially Islamic according to their central banks.
Malaysia, Saudi Arabia, and some other Arabs countries have developed a hybrid financial system where Islamic banks coexist with regular financial institutions, and the monetary authorities of those countries regulate both types of financial institutions.
This increase in the practice of Islamic banking transformed Islamic economics from a sub-field of Islamic jurisprudence and comparatives systems into one which interacts positively with mainstream economics theory.

In this paper we present a basic theoretical understanding of the concept of Riba/ interest, the key principle of Islamic banking. We explore the basic principles of

Islamic banking, the tools of interest free banking and how Islamic banking can be implemented in a hyper-competitive environment.[1]

Introduction

Islamic banking is a growing phenomenon, which came into existence to satisfy the financial needs of devout Muslims who observe the prohibition of interest-based transactions. Many economists have studied the macro-economic properties of this institution in the framework of an isolated and ideal Islamic economy. In this age of integrated global financial market, the instantaneous transformation of an entire financial sector to profit-and-loss sharing is very unlikely. In this paper I present a basic understanding of the principles of Islamic banking and the tools of interest -free banking.

It has been noted by Khan (1986) that the abolition of interest-based transactions is not a subject alien to western economic thought., for instance, Fisher (1945), Simons (1948), Friedman (1969), and others, have argued that the current (One-sided liability) interest-based financial system is fundamentally unstable. This view was made more popular in recent years due to the epidemic of Savings and Loans bankruptcies in the U.S., as well as the financial crises in Latin America (instigated by the ambiguity of the financial positions held by banks seeking higher interest rates on foreign currency denominated bonds). Zarqa (1983), Khan (1986), and a number of

[1] The principle article was by Issam Tlemsani, with valuable contributions by Professor R. Matthews. The paper represents work in progress.

papers that followed have illustrated the macroeconomics stability of a profit and loss sharing system, which would replace interest-based transactions in an Islamic economy. Perhaps the strongest condemnation of profit/lost sharing in the literature is according to Ahmad (1992):

The sad reality is that though every one concedes that Islam prohibits interest, there is not a single Muslim country which is running its financial institutions without resorting to interest. The fact is that no one knows how to do it, and when political pressure mounts, they can only resort to some kind of subterfuge (p.16)

Later, Ahmad (1992) criticizes the Islamic banks under subsections titled *and we claim, we have abolished interest!* , and *Current posture of Islamic Economics* :

It is not clear whom we are cheating (p.47)

The worst part of the story is that Islamic economists, as a body in their International Monetary and Fiscal Conference held in Islamabad in 1981, gave their unreserved approval to this arrangement. So far this is the best that Islamic economics has to offer, viz., change the name of interest and you have abolished interest (p.48).

INTRODUCTION NEEDS TO LINK TOGETHER

PLAN OF THE PAPER

2. Islamic foundations

3. Neoclassical approach

There are hundreds of financial instruments devised by Islamic banks and financial institutions to meet the diverse needs of investors and entrepreneurs. However, all of those instruments derive from seven main methods of financing that are well documented in the juridical literature. Those arrangements are:

- **Mudarabh** (Silent partnership)

This principle of no pain no gain, no one is entitled to any addition to the principal sum if he does not share in the risks involved. Under this system, one party (the investor) provide the capital, and the other (the entrepreneur) provides his time and efforts Profits are shared on pre- agreed basis but losses, if any however, are wholly suffered by the rabbumal (the investor), and entrepreneur has the sole control of the enterprise s management.

- **Musharakh** (partnership)

Financing through equity participation is called Musharakh. Here the partners or shareholders use their capital through a joint venture, Limited partnership to generate a profit or loss this will be split between the shareholders according to some agreed pre-formula depending on the investment ratio. There is no fixed formula for profit sharing and each case is dealt with on its own merit.

The partner in Musharakh has the right to co-manage all projects, Unlike the Mudarabh where the entrepreneur has the sole control of the enterprise s management.

- **Murabaha** (resale contract)

In a Murabaha transaction, the bank finances the purchase of asset by buying it on behalf of its client. The bank then adds a mark-up in its sale price to its client who pays for it on a deferred basis. The cost-plus nature of Murabaha sounds very much like the interest into capital gains manipulations of tax-avoiders (Edward s, W 2000). Islamic banks are supposed to take a genuine commercial risk between the purchase of the asset from the seller and the sale of the asset to the person requiring the goods. The bank stands in between the buyers and the supplier and is liable if anything goes wrong. There is thus some form of guarantee with respect to the quality of the goods provided by the bank to the end user in the strict form of Murabaha title to the goods financed may pass to the bank s client at the outset or on deferred payment.

- **Quard Hassan** (Good Loan)

Literally a good loan . This is a loan by which a borrower is obliged to repay the lender the principal sum borrowed on the loan. It is left to discretion of the borrower to reward the lender for his loan by paying any sum over and above the amount of the principal.

- **Ijara** (Simple leasing arrangement)

Here the banks purchase capital/equipment and lease it out under installment plans to end-users. As in western leasing there may be an option to buy the goods built into the contracts. The installments consist of rental for use and part-payment.

- **Baisalam** (post delivery sale)

When a manufacturer seeks to finance the production of goods he seeks Baisalam financing. This involves the bank paying for the producer s goods at a discount before they have been delivered or even made. It is thus similar the bankers Acceptance financing in the west.

- **Baimuajjal**

It is deemed acceptable to charge higher prices for deferred payments. Such transactions are regarded as trades and not loans. Property financing on such a deferred payment basis is called Baimuajjal. The sale price typically exceeds the spot price of the good by some fixed mark-up, which is negotiated prior to the transaction.

Discussion

It is often noted that the first two arrangements in this list have a strict risk, profit, and loss sharing rule, whereas the other four can easily accommodate a hidden interest rate. Indeed, Islamic banks commonly use an accounting interest rate for bookkeeping these transactions. It is this practice of renaming interest that is so strongly criticized by Ahmad (1992),. Many Islamic banks attempt early in their operations to conduct Mushrakh and Mudarabh but eventually converge to using Murabha, Baimuajjal, and leasing as the main modes of operation. Those practices are commonly favoured due to the elimination of the risks of enterprise failure, moral hazard, and adverse selection.

The Islam Prohibition of Interest

The religious prohibition of interest in the Qur an is revealed to the Prophet Mohammed (pbuh)[1], and in the sayings of the Prophet, as well as the juridical inferences and extensions based on those prohibitions.

It is not surprising in light of this clear prohibition of interest in Judaism and Christianity to learn that the first interest free bank in documented history was established prior to the life of Prophet Mohammed (pbuh)[2]. The first interest-free (Islamic?) bank Agibi Bank was established circa 700 BC in Babylonian, and functioned exclusively on an equity basis Baron (1952).

Saying of the prophet (pbuh):

> *A trading, two goods of the same kind in different quantities, where the increase is not a proper compensation . (Al-Jozayri, 1986)*

And according to Abu Hurairah the prophet (pbuh) said:

[2] Muslims use the acronym pbuh following a mention of the prophet Mohammed. It stands for peace be upon him , when mentioning multiple prophets, pbut stands for peace be upon them

A*void the seven great destructive sins* of which no. 4 is *to eat up Riba (usury)* .

It is important for the assumptions and objectives of our modeling technology in this paper to understand the manner in which the prohibition of riba was introduced and then established in a heterogeneous economic environment. The first verse in the Qur an mentioning riba was revealed in Mecca, and it did not abolish the practice, but echoed the essence of the new testament quote that it does not please Allah, and that true increase with Allah cannot be attained through interest (all translation of meaning here follows Dr. Muhammad Taqu-ud-Din Al-Hilali and Dr. Muhammad Muhsin Khan.)

Ar-Rum (30), verse 39 Part 21 page 545.

And that which you give in gift (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people s property, has no increase with Allah: but that which you give in Zakat (charity) seeking Allah s countenance, then those, they shall manifold increase

Then came the prohibition early in the Madinah, but it was ambiguous whether all interest was prohibited or only exorbitant and or compounded interest:

Al- Imran (3) verse 130 Part 4 page 92.

O you who believe! Eat not riba (usury) doubled and multiplied but fear Allah that you may be successful.

Then, among the very last versed revealed in the Qur an, came the unequivocal and strong prohibition:

Al-Baqarah (2) verses 275-276 and 278-279 Part 3 page 62-64.

Those who eat riba (usury) will not stand except like the standing of a person beaten by shaitan (Satan) leading him to insanity. That is because they say: Trade is only like riba(usury) . Whereas Allah has permitted trading and forbidden Riba (usury). Whosoever receives an admonition from his lord and stops eating Riba (usury) shall not be punished for the past: his case is for Allah (to Judge): but whoever returns to Riba, such are the dwellers of the fire they will abide therein .

Allah will destroy riba and will give increase for sadaqat (deeds of charity) and Allah likes not the disbelievers, sinners .

o you who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury), if you are believers .

And if you do not do it, then take a notice of war from Allah and his messenger but if you repent, you shall have your capital sums. Deal not unjustly (by *asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums)*

Discussion Forum

Clearly the principles which prohibit riba differ markedly from the principles underlying Fisher in interest theory. The logic of Fishers interest theory is concerned with the efficient allocation of resources through time. The interest rate in Fishers analysis indicates time preference on the part of borrowers and lenders. The resultant equilibrium allocation theory and time is pareto efficient.

The Islamic principles are concerned with issues of fairness and justice rather than efficiency narrowly defined. The issue whether principles laid down historically can survive as foundations banking in a hypercompetitive environment pure logic would dictate that this is not possible. However logic would also predict the decline of religion as a necessary accompaniment to economic progress. The growth of Islam as a faith in the late twentieth century confounds this type of logic. So with 1.5 billion Muslims in the world already. Who can sagely predict the demise of a fundamental Islamic principle? Real debate surrounds the question as to what these fundamental principles are, and how they are to be interpreted?

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