



SUPERIORITY OF PROFIT/LOSS SHARING SYSTEM OVER INTEREST BASED FINANCING SYSTEM: A CRITICAL VIEW

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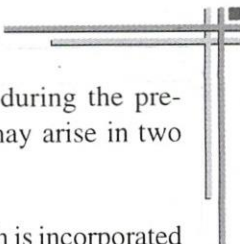
In global economy, two types of return on financing are mainly found: (a) interest and (b) profit/loss share. It is recognized that in the Neo-classical economy the returns of four factors of production are (i) wage for labor, (ii) rent for land, (iii) profit for entrepreneurship and (iv) interest for capital. Therefore, question may arise what is the return of capital at interest free (i.e. loss) financing system or Islamic financing system? How would the return of capital be measured there? What are the disadvantages of interest based financing system which induces to avoid it in Islamic Financing System? What is the logic behind interest free Islamic financing system? This paper will try to find the answers to these queries. This paper will also examine the Profit/Loss Sharing (PLS) system in an interest free economy. In the PLS system the return of capital is called profit share however in traditional system it is called interest. Therefore, how is profit share different from interest, though both are payments for using capital?

Interest (Riba)

The Arabic word 'riba' literally means 'increase in' or 'addition to' anything. In financing system, the word 'interest' is frequently used in terms of riba. Riba is often translated as usury too. When creditor charges an amount from the debtor at a fixed rate on the principal amount, he lent, that is interest or usury. At the time of the revelation of the Qur'an, interest was charged in several ways. For instance, a person sold something and fixed a time limit for the payment of its price, and if the buyer failed to pay it within the fixed period, he was allowed more time but had to pay an additional sum. Or a person lent a sum of money and asked the debtor to pay it back together with an agreed additional sum of money within a fixed period. Or a rate of interest was fixed for a specific period and if the principal along with the interest was not paid within that period, the rate of interest was enhanced for the extended period, and so on¹. Riba has been condemned in the strongest possible term in the holy Qur'an. Islamic jurists have classified usury into two types:

- Usury of debts (riba al diyun)
- Usury of trade (riba al bai')

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The usury of debts was an established practice amongst Arabs during the pre-Islamic period. It is known as usury of delay (*riba al nasia*). It may arise in two situations:

First, as an excess over and above the amount of principal loan which is incorporated as an obligatory condition of giving loan. In this situation it is called *riba al diyun*. In the **second** situation, an excess amount is imposed over and above the amount of the principal loan if the borrower fails to pay the principal on the due date. Thus, more time is allowed for payment in return of excess amount. If the borrower fails to pay again, a further excess amount over the principal (usually the double of the first excess) is imposed and so on. This kind of usury may occur through debt or trade. This is known as *riba al nasia*.

Riba al bai' is also known as *riba al fadl*. It was also practiced by the Arabs in the pre-Islamic period and was prohibited by the Prophet (pbuh). Following tradition of the Prophet (pbuh) is cited as an evidence thereof:

It is related that Abu S'aid al Khudri said: "The Prophet (pbuh) said: Gold for gold, silver for silver, wheat for wheat, barley for barley and dates for dates, the like for like, hand to hand (immediately). Whoever increases or asks for an increase hath (practiced) usury, the receiver and giver alike (are guilty)".

Keeping in line with the above tradition, the Islamic Fiqh Academy established by the Organization of Islamic Conference (OIC) in its second session held in Jeddah, Saudi Arabia, during Riba Thani 10-16, 1410 H (December 22-28, 1985) declared that "any increase or profit on a loan, which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay, and the increase or the profit on the loan at the inception of the loan agreement, are both forms of usury (*riba*) which is prohibited under the Shari'ah."

It is the considered opinion of the experts of Islamic jurisprudence that interest charged by commercial banks "is identical with the excess stipulated as an obligatory condition in the contract, which is one of the two types of usury and prohibited by the Islamic Shari'ah"².

Now, the return of capital in traditional economic system i.e. interest based economic system (Tree Diagram-I) and Islamic Financing system i.e. Profit/Loss Sharing system (Tree Diagram-II) are presented below:

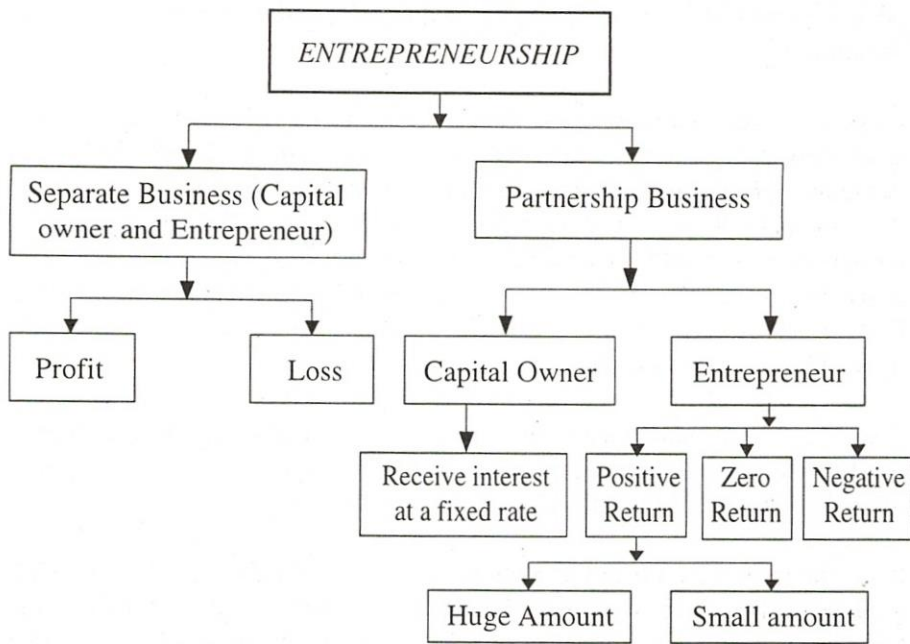


Diagram-I: Interest as the return of Capital

Capital-owner himself may be an entrepreneur. At that case, profit or loss belongs to the same person. In interest based financing system, if capital owner and entrepreneur are different persons or different institutions, returns of capital and entrepreneurship are allocated according to the mentioned system in the above diagram. The return of business for entrepreneur may be positive, zero or negative. The positive return may be a huge amount or small amount. Whatever the return is, the entrepreneur must pay a certain amount to the capital owner according to his agreement. Therefore, in case of huge return, capital owner doesn't receive perfect share of his capital, that means he is deprived. On the other hand, in case of negative or zero profit, the entrepreneur must pay the agreed interest to the capital owner, where the entrepreneur is deprived. How the Profit/Loss Sharing system overcomes this unfair situation is explained hereunder.

Profit/Loss Sharing system in Islam

The prohibition of interest does not, however, mean that there is a prohibition on earning any return on financing. It is possible, within the Islamic framework, to earn income on financing. In Islamic Financing System this earning on financing is being practiced as Profit/Loss Sharing (PLS) system instead of interest.

Profit/loss share instead of Interest in Islam

Interest is an institutional phenomenon specific to the Capitalist Economy. As a matter of fact, the value productivity of capital is uncertain and no rational basis exists for regarding it to be a positive category in all economy³. So, instead of interest for capital, Islamic Economics believes in profit/loss share in joint venture. However, what the basic differences between interest and profit/loss share are can be clarified in a tree diagram, which is as follows:

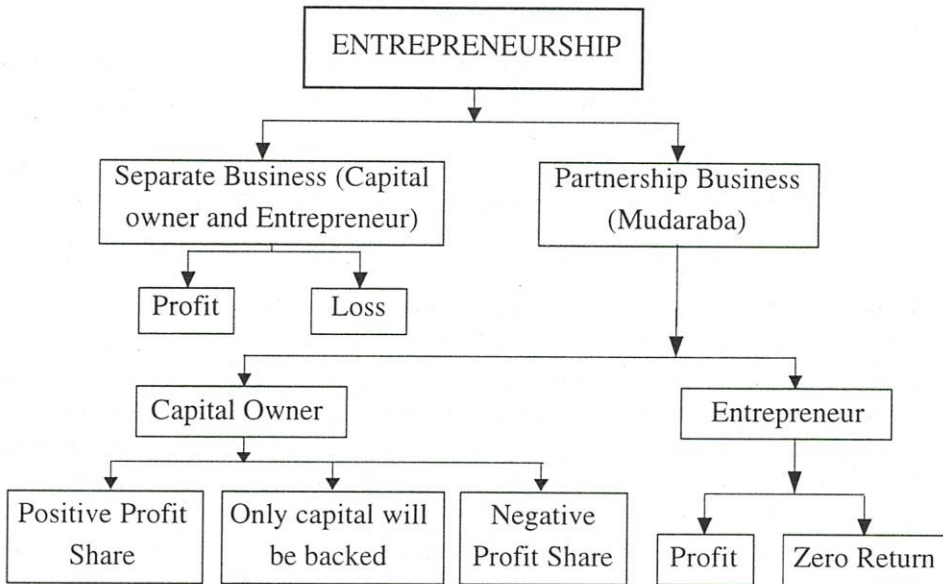
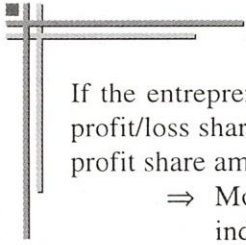


Diagram II: Profit/loss sharing as return of Capital

A man can do business separately or can enter into a partnership. He could engage in a job and earn wages. Earnings from business are different from wages, as they are not contractually fixed. They are in the nature of profits and carry with them the risk of loss.

Interest being prohibited in the Islamic economy, both the reward for entrepreneurship and the return to money capital accrue as profits. But there is a significant difference: whereas the former is either positive or zero and; the latter can be positive, zero or negative.

Suppose, in partnership, one is entrepreneur and another is owner of capital. This is known as Mudaraba in Islamic banking system. We will characterize the income of the entrepreneur as Profits and the return to capital as Profit Share.



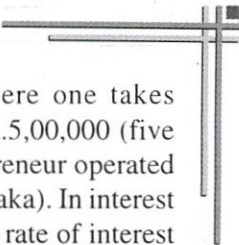
If the entrepreneur himself is the owner of capital, in that case both profit and profit/loss share accrue to him. However, there are three systems of allocation of profit share among the business partners.

- ⇒ More often, the entrepreneur obtains money capital from some other individual(s) or financial institution(s) (i.e. bank). The only way he can do so is on the basis of an agreed percentage of the profits-share. If the business earns a positive-profit, profit is distributed between the partners (capital owner and entrepreneur) according to the agreement.
- ⇒ In case there are neither profits nor losses, the supplier of capital gets back only the capital he has supplied. i.e. the profit share is zero.
- ⇒ In case there are losses, these are borne by the supplier of capital and deducted from the capital before it is returned. The profit share in this case is negative.

Why Interest Based Financing System is not Acceptable?

Interest is the root cause of many evils in the economic life of mankind. In real world, the poor and needy people borrow money for their livelihood at a high compound rate of interest. And ultimately what happens is that these poverty-stricken people cannot repay their loans and hence the amount of these loans including compound interest goes on increasing more and more as a result of which the borrowers are often required to sell their last resort. In this way the lender (the rich) gets access to the last resort of the poor, thus making the poor poorer and the rich richer causing ever-growing inequality in the distribution of wealth in the community.

In modern times loans are usually used for financing production plants and for running business. Interest causes maldistribution of produced wealth among the factors of production. The contributor of capital gets a fixed interest whether any loss is incurred or any profit is made. In case of losses the contributor of capital receives the predecided interest from the entrepreneur, which causes excess burden on him. Because the entrepreneur gets nothing, rather repays full amount of principal along with interest from his own pocket. This loss cannot be distributed between the lender of money and the entrepreneur as would have been in case of Mudaraba business. This disturbs the proper distribution of wealth by illegal transfer of wealth from the entrepreneurs to the capitalist⁴. The following example perhaps will make clear the differences:



Suppose, in Mudaraba system (the partnership business where one takes entrepreneurship and another provides funds) a bank financed Tk.5,00,000 (five lac taka) to a partnership business. Suppose further that the entrepreneur operated the business and accidentally found a loss of Tk.2,00,000 (two lac taka). In interest based financing system, suppose, he borrowed the money on 15% rate of interest per annum. Therefore, he must pay Tk.5,75,000 at the end of term. However, he has only Tk. 3,00,000 in his hand. Hence, how would it be possible for him to pay the outstanding Tk.2,75,000? To pay this amount either he has to borrow again from another bank or he will get in the black grip of compound interest. It is inhuman.

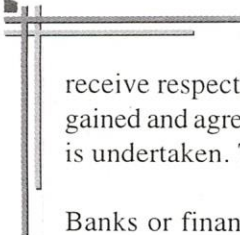
On the other hand, by investing Tk.5,00,000 if the Mudarib (*entrepreneur of the Mudaraba business*) gains a profit of Tk.2,00,000 (suppose), the entrepreneur will receive Tk.1,25,000 net profit whereas financier will receive only Tk.75,000 from the business though he supplied the whole capital. It is also illogical and irrational. That means traditional economy never considers the position of the Mudarib whether he receives a huge amount of profit or he gets loss.

On the contrary, in Profit/Loss Sharing (PLS) system the way of profit distribution is totally different and rational.

In PLS system, which is followed in Islamic financing system, the Mudarib has to pay the agreed profit share to the capital owner if he gains profit. In case of loss, it will be borne by capital owner i.e. bank. In the above-mentioned business, the loss of Tk. 2,00,000/- will be borne by the bank normally. Nevertheless, if it is proved that the loss occurred for intentional misuse or irresponsible use of funds, then the loss will be borne by Mudarib. This system is quite logical because a financial institution can invest capital in multipurpose. In most of the cases it receives profit-share. Accidentally in one or two cases it finds loss. Therefore, it is not a matter for him to bear the losses. However, to bear the loss is impossible for the entrepreneur because he borrowed money, as he is unable to provide the capital of business.

On the other hand, in case of Tk.2,00,000 profit, the bank will receive profit-share according to the agreement made. If the agreement is on (say) 50% -50% profit share then the capital owner will receive Tk.1,00,000 plus his principal amount. And the entrepreneur will receive a profit of Tk.1,00,000.

In fact, profit can never be a predetermined amount. It may be larger or smaller; positive or negative; may be no profit, no loss. Whatever it is, the distribution will be on agreement basis. Here both entrepreneur and capital owner bear risk. Accordingly, the profit and profit share, which the entrepreneur and capital owner

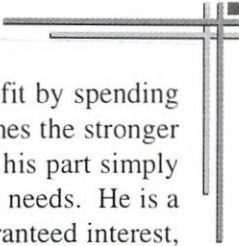


receive respectively, are not fixed or predetermined. It varies on the basis of profit gained and agreement made. Note that agreement would be made before the business is undertaken. This system is quite rational and accepted in Islam.

Banks or financial institutions also can act as entrepreneur where depositors are capital owners. In that case profit-share would be distributed by following mentioned PLS method. In different years like 1985, 1990, 1995 and 2000, following the PLS system, Islami Bank Bangladesh Ltd. offered 5%, 15%, 18% and 25% dividend respectively.⁵

It should be mentioned that some people try to interpret that there is no basic difference between interest based and PLS financing systems. They place the argument that the traditional financing systems allow interest directly. However, Islamic financing system (PLS) also does the same thing but in a different way. The reader may have found the actual differences between these two systems from the above discussion. In brief, the fundamental differences can be presented as follows:

- (i) As far as the moneylender is concerned, he gets that fixed sum of interest which he fixed earlier and considers as his profit. If the debtor spends the borrowed money in fulfilling his personal needs, the time factor definitely does not bring any profit at all. And if he invests that money in trade, commerce, industry, agriculture, etc., then there are equal chances of profit or loss. Thus lending money at interest might bring a guaranteed and fixed profit to one party and loss to the other, or a guaranteed and fixed profit to one party and an uncertain and indefinite profit to the other. That means the full risk is borne by the debtor.
- (ii) The investor earns profit and distributes profit-share among the capital owners and holds his portion according to the agreement but money-lender goes on charging interest over and over again and goes on increasing with the passage of time. The profit which the debtor makes on money of the creditors, however large it maybe, has after all its own limits. But there is no limit to the interest the creditor may charge on his money. He may, as sometimes actually happens, receive all the earnings of the debtor, may even deprive him of all the means of livelihood or of the articles of his personal use and still might have the same amount of debt against him that was at the time of borrowing.

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- (iii) One engaged in trade, industry, agriculture etc., earns profit by spending time, labour and intelligence, but the money-lender becomes the stronger in the earning of the debtor without any risk or labour on his part simply because he invests the money which is over and above his needs. He is a partner only to the extent that he is entitled to a fixed guaranteed interest, irrespective of whether there is any profit at all or how much, or whether there is even a loss.

From the above discussion it becomes quite clear that even from the economic point of view, trade helps construct society but interest leads to its ruin. As for the moral point of view, interest, by its very nature, creates parsimony, selfishness, cruelty, hard-heartedness, money-worship, etc., and kills the spirit of fellowship and co-operation. It is, therefore, ruinous for society both morally and economically and thus it is strongly prohibited in Islam. Therefore, interest should be avoided in all respects. Instead, for the welfare of society as well as to obey the order of almighty Allah, Muslims must accept the system of PLS on financing. Some verses from the holy Qur'an are quoted below in this respect:

“O Believers, fear Allah and give up what is still due to you from interest, if you are true believers; but if you don't do so, then take notice of war from Allah and His Messenger. If, however, you repent and forego interest you are entitled to your capital, do no wrong, and no wrong will be done you. If your debtor be in straitened circumstances, give him time till his monetary condition becomes better. But if you remit the debt by way of charity, it will be better for you, if you only knew it”⁶.

The Muslims are also warned to abstain from interest and obey the Commandment of Allah, or else they shall suffer the fate of the Jews, who were forbidden to take interest, but they continued to do so. “Because they take interest, which had been prohibited, and because they devour unlawfully the property of others. And we have prepared a painful torment for the disbelievers”⁷.

The holy Messenger of Allah, on his last Pilgrimage and in his last address, declared the prohibition of interest in these words: “Every form of riba (interest) is cancelled; capital indeed is yours, which you shall have; wrong not and you shall not be wronged. Allah has given His Commandment totally prohibiting riba (interest). I first start with the amount of interest which people owe to Abbas and declare it all cancelled.” He, then, on behalf of his uncle, Abbas, cancelled the total amount of interest due to his loan capital from his debtors”⁸



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- ⁴ Distribution of Wealth in Islam, Abul Hasan M. Sadeq: Thoughts on Islamic Economics, Islamic Economics Research Bureau, Dhaka, p.81
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- ⁶ Al-Qur'an, 2:278, 'ECONOMIC DOCTRINES OF ISLAM', op.cit. p.111)
- ⁷ Al-Qur'an, 4:161, ibid, p.111
- ⁸ Imam Malik, Mautta, ibid, p.112
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