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The concept of interest in the Western and Middle Eastern society

Mustapha Ben Amira

THE CONCEPT OF INTEREST IN THE WESTERN AND MIDDLE EASTERN SOCIETY

A Thesis

Presented to the

Faculty of

California State University,

San Bernardino

In Partial Fulfillment

of the Requirements for the Degree

Master of Business Administration

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by

Mustapha Ben Amira

December 2003

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Approved by:

[redacted]

Rauf Khan, D.B.A., Chair, Accounting & Finance

11/26/2003

Date

[redacted]

Nabil Razzouk, Ph.D., Marketing

[redacted]

Otto Chang, Ph.D., Department Chair, Accounting & Finance

ABSTRACT

The world banking systems operate on different types of regulations that vary from country to country, depending on cultures; religious, social and economic objections.

For example, the entire banking system in the Western counties, including the Anglo-Saxon and the European continents, is operating based on the concept of interest. Customer's deposits are channeled into a variety of short term and long term loans and the bank charges the borrowers interest on its loans and pay its depositors interest on their deposits. In contrast, the banking system in the Middle Eastern countries is operating differently. The banks, in this particular region, are founded under the Islamic law and regulated on profit sharing basis, a system that prohibit the use of interest. Indeed, these interest free banks invest depositor's funds in various types of businesses and a potion of profit earned is paid to depositors in a pre-determined profit and loss ratio.

These differences in bank regulations had evoked different interpretations of the concept of interest. In fact, that there are divisions, among the world

economists, regarding whether or not, modern-day bank interest, should be eliminated and prohibited.

Toward interest free society, is the idea behind removing interest-based practices from the economic system, suggested by some economists, being against the use of interest. The argument of eliminating interest is highlighted in the paper, detailed and proved at one level, by the world's recent economic crises and also, by the social consequences resulting from the interest's dominance in the capitalist system. The analysis of the topic is further supported, by examples and evidences exposing the flaws in the current western financial system and the actual necessity for a universal resolution. For this perspective, the Islamic banking model - profit sharing system - was created, as an attempt to over come the weaknesses of the conventional system and to solve problems of the present economic system .in addition, the potential reform aim to redesign and build a new interest free society, free from the threat of accumulating debts.

A comparison of banking services and an evaluation of the effectiveness of both systems is presented also in the paper, to see at which extent the profit sharing could be an ideal substitute to the interest system, taking into account their economic and social benefits, and the circumstances on which they were founded.

A final issue was exposed, concerning the widespread and the degree of success of interest free systems in to day's life. The system is successfully operating now in the Middle Eastern countries, but how can replace the western interest based system and if the reinstallation is feasible how can be implemented in the western society, in a hyper-competitive environment such as the US market?

The answer for these questions comes through a detailed investigation of interest free mortgage financing, one product of the profit sharing banks, and a long with Strategic alternatives to effectively targeting the US market.

ACKNOWLEDGMENTS

I would like to dedicate this master's project to my parents, Mr. Salem and Mrs. Zohra Ben Amira, to whom I will be forever grateful for their love and support.

I have been blessed with two of the most wonderful parents who have never denied me the opportunity to better myself. They have provided me with the opportunity to continue my studies abroad and achieve my master's degree.

To my father Salem, you have been my inspiration for fighting for my future. You have taught me to make the best of my qualities work toward my advantages. You have assisted me in every way possible to reaching my dreams and to you I owe my deepest gratitude. I will never forget the many times I have sought assistance and understanding from you.

To my mother Zohra, I must admit that your duties as a mother have been fulfilled. I realize now that all you have done for me was for my own good and I hope I have made you proud. I will never be able to thank you enough. I love you.

To my sisters Fatma, Safia and my brother Hichem, words cannot express the love and gratitude I feel for you. I wanted to tell you "THANK YOU", you believed in me when I didn't believe in myself, you have supported me, encouraged me, and assisted me in reaching my full potential dreams. I couldn't have done it without you.

To my advisor Dr. Rauf Khan, I would like to thank you for your patience, kindness, expertise, and guidance for this master's project. You assistance with this project was greatly appreciated; you will never be forgotten.

I would like to extend my most heartfelt gratitude to Dr. Nabil Razzouk. Your editing ability and worthy suggestions through the many stages of this project are deeply appreciated. I thank you for your patience and understanding.

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LIST OF SYMBOLS

Distinguishing features:

☪ For profit sharing paradigm

✿ For traditional paradigm

Guide to diagrammatic illustrations:

Financial flows ....

Returns financial flows ·—··—··—

Real flows (goods/usufruct/services) ————————

Direction of flows ← → ↑ ↓

Sequence of transactions (1), (2), (3), (4)

Simultaneity in transactions process (1a) & (1b) and (4a) & (4b)

Two commitments at the transaction stage (1b) are: (1b.1) and (1b.2)

CHAPTER ONE

INTERPRETATIONS OF THE TERM "INTEREST"

Historical Overview

Until a few hundred years ago, any extra amount demanded by a lender beyond the original capital, was referred to "interest". Early European philosophers and economists condemned the practice of taking interest. The Roman Empire, in its early stages, prohibited charging of interest. The Christian Church also, prohibited all usurious transactions. However, with the expansion of trade in the 13th century, the demand for credit increased, necessitating a modification in the definition of the term.

In 1545, England fixed a legal maximum interest; any amount in excess of the maximum was considered usury. The practice of setting a legal maximum on interest rates was later followed by most states of the United States and most other Western nations.

Thus, beginning in the mid-sixteenth century, the prohibition of interest was legally removed in all Western countries. The environment, in which it took place, was marked by the expansion of trade and demand for credit.

Borrowers were mainly the rich merchants, and they used the short-term credit for buying and selling goods.

The moneylenders were lending their own money or that of their wealthy clients. The borrowers knew how much they could make using a given amount of credit, and they paid the lenders a portion of this profit. This supplied the justification for demanding the extra amount.

But this justification for "limited interest" under a particular circumstance was, in the course of time, stretched out and applied in general. Now that the new "moderate" form of interest was legal and "moral", economic theories were developed with this limit and justification as the base. More theories were developed, and interest became an integral part of economic theory. In practice, the theory of interest was applied universally and reinforced, in such way that it becomes nowadays, difficult to think of any economic theory or activity without interest being an integral part of it.

For example, in 1545, when the "legal maximum interest" rate in England was fixed at ten percent per annum, it did not remain fixed for long. It varied from time to time and from place to place, depending on the economic and political circumstances. Eventually, the concept of "maximum interest" ceased to exist, and interest as a word even went into disuse. Today, practically everywhere in the world, charging and paying interest is legal, no matter how much, and it is acceptable both in theory and practice.

Bank Interests from a Western Perspective

With the invention of the modern commercial banks, as an intermediary between the depositor (the fund-provider) and the borrower, two types of interests emerged. One, the interest the bank paid to its depositors, and two, the interest it charged to the borrowers. These banks operate under the principle of "The latter is always larger in magnitude than the former."

To illustrate, the depositors may be paid 5 percent while the borrowers are charged 15 percent, and the difference is the due to the bank. The difference or the spread between the two rates consists of components such as the real costs it incurs in providing the service, a risk premium against possible defaults, compensation for inflation and its own profits.

Today, a fixed deposit in a bank is considered as an investment because it earns a return, and a loan is considered as an asset by the bank for the same reason. But they are both interest-earning loans. Whatever the purpose, money, according to the western system, is available only as a loan at interest. The lenders (both the depositors and the bank) are not really concerned about whether the money was invested in any productive activity or consumed; neither is their return related to the result of any productive activity in which their capital was used. Even when the loan is intended for consumption or the investment resulted in loss, the pre-determined interest must be paid.

Bank Interests from a Middle Eastern Perspective

The term "interest" was defined and interpreted in the Middle East countries, fourteen centuries ago, since the appearance of the Islamic religion's law, under which, the whole banking systems operate.

Indeed, Islam permits profits and increase in capital by trade and traffic for mutual satisfaction. At the same time, it blocks the way for anyone who tries to increase his capital through lending on the basis of interest, whether it is at a low or a high rate.

Reasons Why Islam Prohibit Interest Based Transactions

The strict interdiction of Islam on interest is a result of its deep concern for the moral, social and economic benefits of mankind. It is aimed to eliminate the sources of misery and enslavement of the weaker sections of society, to reinforce social expenditure for the needy, and to restore business principles to equilibrium through profit-sharing, equity participation and justice to all concerned. In another sense, Islam disallows unjust enrichment or income, and the transfer of unjustified and instantaneous property rights from the borrower to the lender, which the power of lending money on fixed return or fixed rent creates. Money from this perspective has to be subject to risk and time participation to earn a return.

Meanings of the Term "Interest"

The term "interest" has a broader sense in Islamic law. Etymologically, the word interest signifies augmentation, increase or gain. The increase in question, originates either in the thing itself or in an exchange or sale of one dollar for two dollars.

Although the increase or income itself is accepted in Islam, an unjustified increase or a gain received without a counter value is forbidden. According to the law consultant, Dr. Salah Nabil, "interest is an unlawful gain derived from the quantitative inequality of counter values in any transaction purporting to effect the exchange of two or more species, which belong to the same gems and are governed by the same efficient cause." (Unlawful Gain and Legitimate Profit in Islamic Law, 1992.)

Another economist on this matter affirms that an extensive investigation of various forms of business and credit transactions containing the element of "interest" may help define interest as "a predetermined excess or surplus over and above the loan received by the creditor conditionally in relation to a specified period.

It contains the following three elements:

- Excess or surplus over and above the loan capital
- Determination of this surplus in relation to time
- Stipulation of this surplus in the loan agreement"

(Economic Doctrine of Islam, 1976).

From this point of view, these three elements jointly constitute interest and any deal or bargain or credit transaction, in money or in kind, containing the three elements, is considered as interest transaction. The above three elements can be identified in the meaning of interest because they are interchangeable and are used for the addition or excess paid or received over and above the principal advanced as a loan.

Others interpretations of the concept of interest, confirm that Islam has fixed a zero rate of interest as its legal rate and any rate above the zero rate is a usurious rate of interest.

Finally, a more comprehensive and accurate explanation of the concept, is articulated by Tanzilur Rahman, who decreed that "A transaction which contains excess or addition over and above the principal amount of loan, which is predetermined in relation to time or period to be conditional to the payment of predetermined excess or addition, payable to the creditor constitutes interest and any sale, transaction or credit facility, in money or in kind, has been considered to be a transaction of interest, which is unlawful in the territory of Islam and in Muslim Society" (Interdiction on interest, 1999).

By the same token, the Islamic perception of interest, emphasized on the fact that there is no difference whether the loan is for consumption purpose or for commercial purpose. In other words, it does not matter if the rate of interest is low or high, simple or compound, for short or long term. Equally, it does not matter whether, interest based transaction takes place between Muslims or between a Muslim and a non-Muslim or between a citizen and a State or between two States. Any excess amount that is predetermined over the principal sum in a loan transaction will constitute interest in all circumstances.

The Islamic law's banning of interest is, therefore, the outcome of a noble purpose to protect the weak against the economic exploitation of the rich and at the same time to encourage investors and laborers to combine their resources in joint ventures where profit and loss may be shared. Lending money for profit is then considered as being ruinous to the borrower, immoral for the lender and therefore unlawful under the Islamic teaching.

This contention may be substantiated as the very act of lending money, on the basis of interest, reflects the fact that the lender only cares for the principal capital and additional payment to be paid by the borrower under all circumstances. The lender is neither concerned about the status of loaned money or the detrimental position of the borrower. This argument gets ever stronger when the borrowing party is a person who needed the loan to meet an unforeseen accident or emergency. In this situation, the borrower is economically at his weakest position under a dire pressure of necessity. He has no option to choose except borrowing money. This relationship is never fair and equal because only one party covers the risk and the other enjoys a fixed profit.

It is unjust for the lender to demand a fixed return over the principal sum lent irrespective of what happens with the money lent and of serious detrimental position of the borrower.

Conclusion

Obviously, interest is one of the most unjust, unfair as well as immoral means of commercial transaction, which grossly violates all norms of good faith and that's way, it is strictly prohibited in Islamic Law. From the other side, the loan transactions in capitalistic economic system under the common law discipline are based on interest. In this respect, the common law is yet to develop another piecemeal solution for the protection of the weaker party if it wishes in response to require good faith and fair dealing in lending operations.

CHAPTER TWO

ANALYSIS OF THE INTEREST FREE AND INTEREST BASED BANKING SYSTEMS

Introduction

Money lending is one of the oldest professions in the world. It had been practiced everywhere in the world in various forms. The regulated bank lending is the modern and the professional form of money lending. It operates on different types of regulations and rules that vary depending on regions; cultures; religious and social objections. In order to demonstrate the salient differences in bank's regulations; the following analysis will focus mainly on two banking models, considered as the most extremely different systems in the world, one implemented in the Western continent and the other, in the Middle Eastern countries.

Main Features of Both Systems

The entire banking system in the western societies is based on the use of interest. The bank charges the borrowers interest on its loans and pays its depositors interest on their deposits. In the other hand, the Middle Eastern banking system is an interest free system that prohibits the use of interest, either in receipt or in payment.

Interest Based System Versus Interest Free System

In conventional banking, the bank charges the borrowers interest on its loans and pays its depositors interest on their deposits. The interest rates are predetermined and are guaranteed. The borrower is required to pay the interest that applies to the loan and the lender will receive the promised interest in addition to the return of their initial deposit.

In contrast, the interest free banking, mainly located in the Middle East region, operates on a profit sharing basis. Indeed, the bank invests depositor's funds in various types of businesses. A portion of profit earned is paid to depositors in a pre-determined profit and loss ratio.

In the case of conventional banking, the rate of interest is determined in advance regardless of the end result. However, investors of interest free banks, have no right to demand a fixed rate of return. Only a portion of profit earned is paid to those investors in a pre-determined profit and loss ratio. Investors are also considered the main source of funds, and this source take one of the two forms of deposits, transactions deposits or investment deposit.

- Transaction deposit: are guaranteed the nominal value, the bank would pay no return on this type of liability. Generally speaking, funds mobilized through this source cannot be used for profitable investment by banks .In addition, banks are likely to levy a service charge on deposit holders to cover the cost of administering this type of account.
- Investment deposit: constitute the principal source of funds and they more resemble shares in a firm, rather than time and saving deposits of the customary sort. The bank offering investment deposits would provide no guarantee on their nominal value and would not pay a fixed rate of return Depositors, instead, would be treated as if they were shareholders and therefore entitled to a share of the profits or loses made by the bank.

Another obvious difference is the bank's profitability. In the western countries, the bank's profitability depends greatly upon the margin between the borrowing and the lending rates. However, in the case of a

Middle Easter's banks, the profit or loss should be shared with the investors, based on a profit or loss sharing ratio, which has to be agreed in advance of the transaction, and cannot be altered during the life of the contract. Accordingly, in the Middle East, both the banks and the investors bear every risk of the projects financed. So, if the project produces revenue and gains a profit as expected, they have to share the result as mentioned in the agreement over the contribution basis and portion of investment paid. But in case of loss or damage, the same agreement will be applied and the loss will be borne proportionally as agreed.

Effectiveness of Both Systems

The Economic Considerations

The basic of commerce is to make profits of its activities, and that's the reason why every investor expects the maximum yield for their investments. From this perspective, the profit sharing system seems to be more efficient than the interest-based system because it is founded and operated on the principle of "any additional results is compensated by an increasing amount of profits". However, the interest based system, rewards the capital invested only by a fixed amount of profits since it is based on a predetermined rate of return.

At one level, Interest is a deterrent to productive economic activity. This is evident from the commonly observable facts that when the rate of interest is low, economic activity increases and people are more willing to start and expand businesses, which adds positively to the economy. Quite the opposite, when interest rates are high, people tend to be discouraged from making real investments and are more interested in saving that money and earning interest on it. This is not good for the economy because, when a small entrepreneur gets discouraged from borrowing money and starting or expanding his business due to high interest rates, the country loses out on small scale and medium sized businesses. Both small and medium sized businesses are vital to a healthy economy because they provide employment to many people. They also add to productive efficiency of the economy because due to meager resources, they cannot afford wastage and inefficiency, like the large businesses can. Therefore interest is a hindrance in the development of small and medium size businesses, and hence, a hindrance in the healthy economic activity. In addition to that, Interest rates have a component of risk premium. This risk premium is, to a large extent, based on perceptions of the investors regarding how a company will perform in the future. Since interest rates might be fixed well in advance of the actual performance of the company, a well-performing company may end up paying a higher rate of interest than a poor-performing company because the expectations with the latter were higher initially. So a lot is dependent on future expectations rather than actual facts that tend to have a minimal effect. This is not the case in profit and loss sharing, where equity holders can share in the profit only after the company has performed well and has actually made a profit. This way, the profit and loss sharing system rewards the owners of the business when a business performs well, while in an interest based system; actual good performance of the business has little effect on a pre-determined interest rate.

At another level, the interest rates have poor effect on the economy. The western economic model had experienced so many crises and so long periods of high interest rates. As a consequence, individual investors have gotten discouraged from borrowing money and starting new Business. The alternatives for them were, lending to the large corporations, either indirectly through banks by becoming depositors, or directly through capital markets.

These large corporations can afford to pay high interest rates. They can also get the interest rates negotiated due to their monopolistic bargaining power. This increases economic dependence of the western countries on a few large corporations and stifles growth of small and medium sized businesses, which are essential for a country's economic health and economic competition. Often these large corporations are the western giant multinational companies (MNCs) with huge resources at their disposal. By the time, these MNCs with a monopolistic position, have destroyed the small industrial base, and consequently, have caused problems with sovereignty, culture of countries as well as financial crises. Based on these economic considerations, it is important to note that interest is so risky for building a safe and prospers economy, and it had been playing its part in perpetuating economic inefficiency and unproductively, especially, in the Western countries. Further, interest perpetuates inequity in the distribution of resources. In short, interest based practices, gives rise to inefficiency and inequity, the two major concerns of the discipline of economics, therefore, the profit sharing system, as an interest free system, should be regarded as the appropriate alternative for creating a healthy economy.

The Social Considerations

The western financial systems are called also "Capitalist Systems". In fact, these systems have dangerous social effects. It makes people living in these areas, suffer from certain social threats and pressures, whether they themselves participate in the system or not. "A society that can borrow money on interest is given permission to spend its future in the present time." (The Review of Religions.1994) .In these particular societies, people live in an illusion, a desire to spend money on luxurious articles and enjoying high living standards even though, their incomes and earnings are not enough to satisfy themselves. As human's beings, those people's impatience is without limit and to fulfill their desires, they turn to banks or any credits institutions, to borrow money at interest. For example, in the United States, on average, every citizen owns twenty-five credit cards. This act is considered as "borrowing from the future " which mean, people got themselves burdened with debts, sometimes impossible to pay it back. Starting at an individual level, this act of borrowing becomes a national one and it has been continuing and becoming more and more complicated. In fact, an industry that flourishes on this system is catering for the requirements of the day or the year and expands itself on a requirement that is not natural but artificially boosted. With time, the buying power is reduced until it reaches a point where the buying power of the country as a whole is reduced and servicing the debt itself, becomes a huge problem for the country. For example, " Germany itself is passing through a phase of rebuilding its economy and absorbing the large number of Germans from the East. Among them is available excellent know-how and expertise, which has been paid very little in the past. They are now a part of the West Germany economy and stand on an equal footing and so the level of production, after an initial shock, will rise so rapidly that the rest of Europe will find itself shuddering at the prospect of the boosted German economy". Russia is a second example. "It will not remain the Russia of today which is still suffering from the aftermath of the destruction of the communist system. The USSR is a huge country, or a number of countries grouped together, whose economy is potentially stronger than that of many Europeans countries. Once they have had the breathing time to regroup themselves and to change their system to a capitalist one, then a course of events similar to that of Germany would follow. So now, what the situation of Europe will be, with lessening buying power, increasing economic problems and increasing competition. Such crisis always lead to war and this is a fundamental principle that can never be negated" (The Review of Religions, 1994).

Comparability in Bank's Regulations

Bank's regulations vary depending on factors such as regions; cultures; religious; economic and social objections. All these factors are the main reason for the differences that exist between the Western concept of interest in one hand and the Middle Eastern profit sharing concept in the other hand. The following table, summarizes the main differences of both systems:

Table 1. Interest Based System Versus Profit Sharing System

Interest Based System	Profit Sharing System
The yield factor is determined in advance without considering whether the project gain the profit or loss	The profit sharing agreement is agreed in advance based on the possibilities of gain a profit or loss
The interest is applied over the amount of principles or capital invested	The portion of profit sharing agreement based on the result achieved
Interest payment is fixed	The profit sharing is applied variably, it depends on the project's result
There won't be any increase in interest payment even the project produce more	The profit sharing amount will be surely increased respectively to the result of the project

(Muamalat Bank, 1994)

Foundations for Modern Banking Operations

Currently, western banks, mainly commercial banks, have some capital of their own that is mostly used to provide the infrastructure for banking activities. They almost invariably acquire funds from savers on the basis of interest, and provide those funds to prospective users again on an interest basis. Thus, apart from safe-keeping of valuables, providing funds collection and transfer services and verifying credit-worthiness of their clients, the banks act as pure financial intermediaries that do not get themselves involved in economic activities, such as trading or investment. While investment banks do venture into trading and direct investment, funds are mostly raised as well as committed on an interest basis.

From another side, the profit sharing banks are more concerned with their client's benefits. These banks had created their own design and had established new regulations and alternatives, in order to remove interest from the daily basis transactions. These alternatives are conceived in the border context of permissible forms of transactions for banks

The following tables (Table 2 & Table 3) summarize the fundamental differences between the profit sharing and traditional financing paradigms.

Table 2. Foundations of Profit Sharing and Traditional Financing Banks

• The profit sharing paradigm: financial intermediation is aimed at addressing concerns of depositors and meeting needs of end-users of funds in the framework of permissible forms of transactions in the Islamic law.
• The traditional paradigm: financial intermediation is carried out on the basis of (interest-based) lender-borrower relationships between depositors and banks on one hand and bankers and end-users of funds on the other.

Quoted from: "blueprint of Islamic financial system including strategy for eliminating of Riba. (May-june 1997)"

Table 3. Role Functions of Players on Financial Scene

Relation of	Islamic Set-up	Traditional Set-up
Depositors to banks	(i) Lenders (ii) Partners	Lenders
Banks to End-users of Funds	Economic Agents (Sellers, Buyers, Partners).	Financiers (Lenders)

Quoted from: "blueprint of Islamic financial system including strategy for eliminating of Riba. (May-june 1997)"

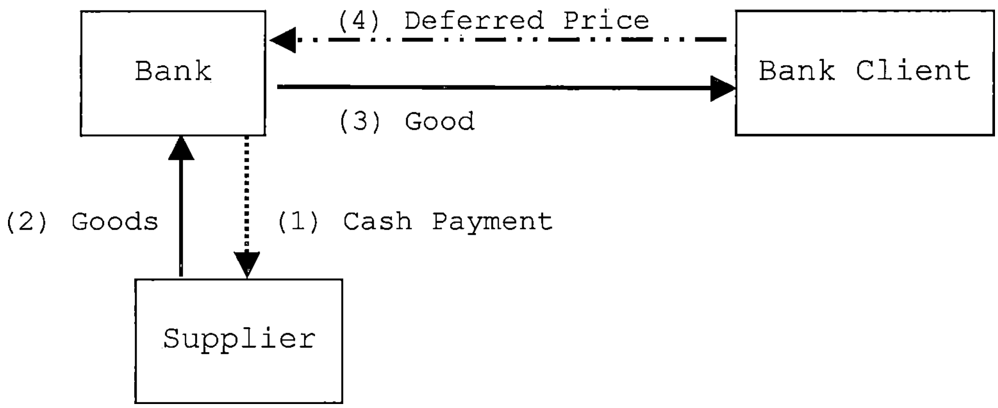
The profit sharing banks have been adopting the following arrangements in the application of funds, in order to maintain their missionary objectives, which is the build of interest free society.

Trading Based Arrangements

One service provided by the profit sharing bank to their customers, is the sale on deferred payment basis. The service is targeting large market segment, particulary, the bank client who desire to purchase and own a good without having the sufficient amount of money needed for the transaction. The bank plays its intermediary role between the client and the supplier. The deferred payment becomes debt against the buyer payable in sum or in installment. The price to be paid must be agreed and fixed at the time of the deal .It may include any amount of profit without qualms about the prohibited interest. Complete possession of the thing in question must be delivered to the buyer, while the deferred price is to be treated as debt against him. A second form of trading service, offered by the interest free bank is sale that involves advance payment to a party for delivery of a thing in future. This form of trading is applied to the case of wholesalers acquiring goods from manufacturers and supplying them to the retailers. The natures, quality and

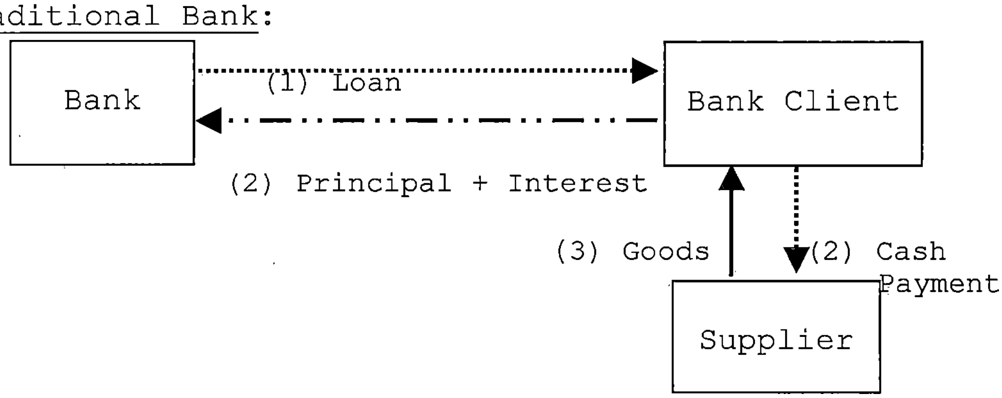
Bank client wants to purchase and, thereby, own a good

Profit Sharing Bank:



- Financial flows run parallel to real flows
- Claims of bank/obligations of bank client are time-invariant

Traditional Bank:



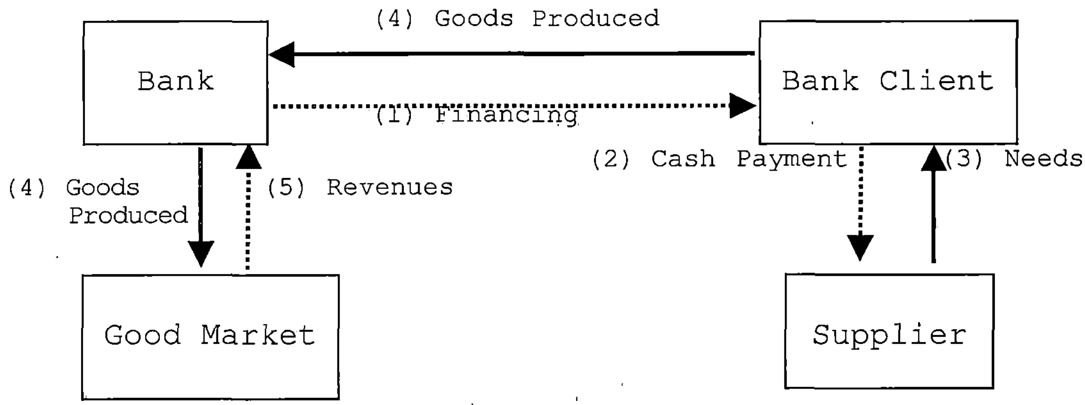
- There is a dichotomy between financing and the use of funds
- Claims of bank/obligations of bank client are adjustable

Figure 1. Trading (Sale on Deferred Payment Basis)

quantity of the merchandise to be delivered in the future must be clearly specified along with the delivery date. The price to be paid in advance should also be fixed.

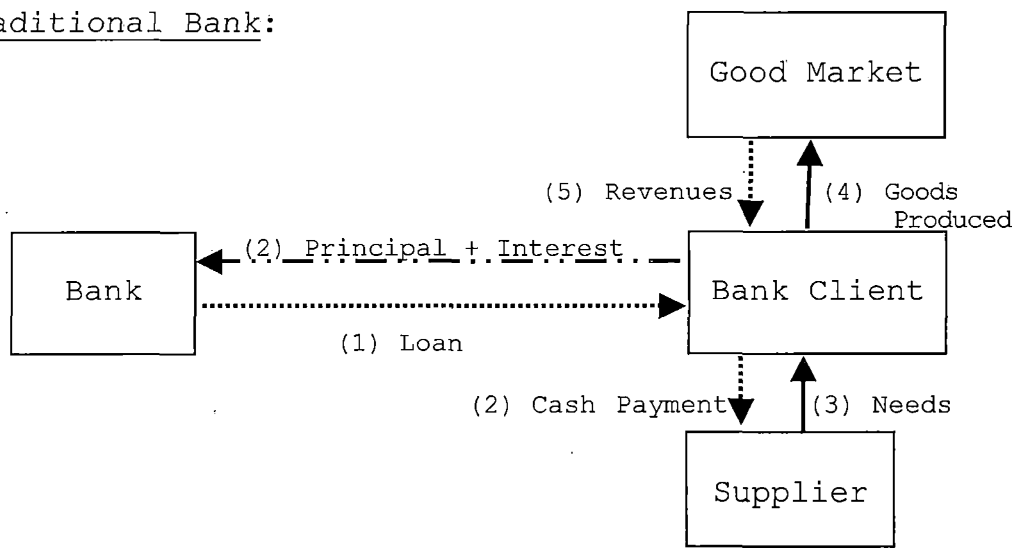
Bank client needs financing to meet his need, and can pay back in terms of/with the help of good produced-whether using the funds acquired or without them-in his own name.

Profit Sharing Bank:



- Financial flows run parallel to real flows
- Bank can recover its financing through disposing of the merchandise in the goods market.

Traditional Bank:



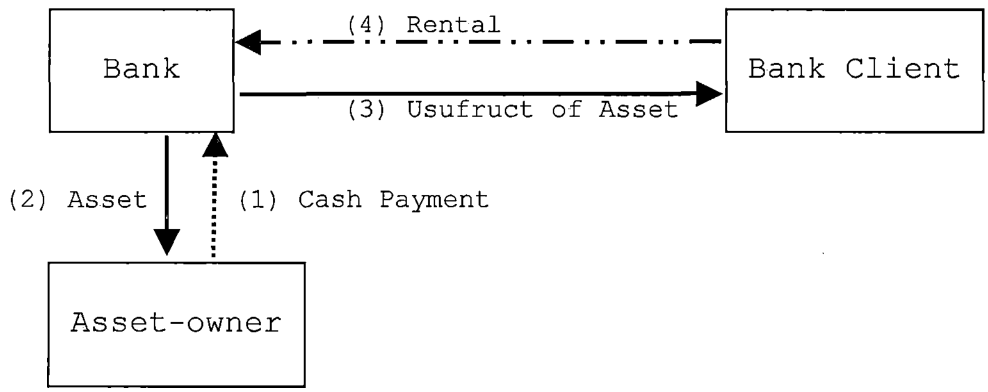
- There is a dichotomy between financing and the use of funds
- Claims of bank/obligations of bank client are adjustable
- Bank has no interest in recovery of the loan in the form of goods produced

Figure 2. Trading (Sale that Involves Advance Payment)

Leasing Based Arrangements

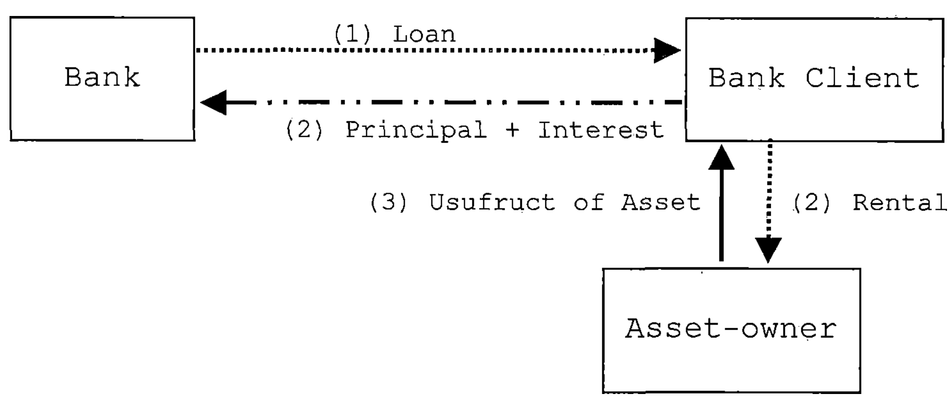
Other set of arrangements made by the profit sharing banks, concern the leasing operations. Leasing is a contract for the usufruct of an asset while its ownership still remains with the original owner. The owner leases his asset to another party, the lessee, against a predetermined rental for a prescribed period. According to the regulation rules in the manuals of profit sharing banks, the fundamental conditions for a valid leasing contract are: the asset should be the property of the owner, the period of contract should be specified and the rental and its payment schedule should be precisely stated. Again the bank gets involved, as an intermediary between the client and the asset-owner. Similarly to the trade arrangements, the goals of profit sharing banks from this new reorganization in the leasing operations, is to remove the element interest from every day leasing contracts.

Profit Sharing Bank:



- Financial flows run parallel to real flows
- Claims of bank/obligations of bank client are time-invariant

Traditional Bank:



- There is a dichotomy between financing and the use of funds
- Claims of bank/obligations of bank client are adjustable

Figure 3. Leasing

Partnership Based Arrangements

Interest free banks are well known for two modes of financing: Profit sharing & equity participation. Profit sharing is a financing mode in which one partner provides capital while the other provides his effort or expertise. The second mode occurs when both partners contribute to the capital, it becomes an equity participation-financing mode.

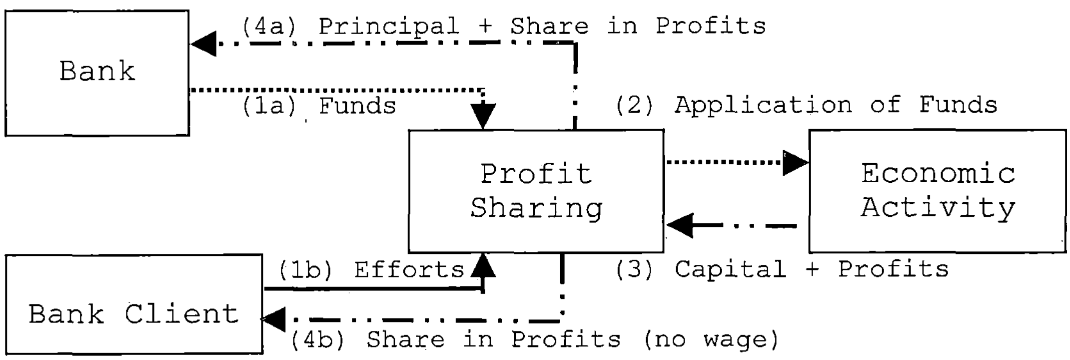
Several possibilities exist with more than two partners in the picture. It is possible that some may contribute to equity while the others put in their efforts. Technically, this would be equity participation among the former (equity holders) but a profit sharing between the former and the latter (contributing to effort). Similarly, there is also the possibility of some partners contributing on both the equity and the effort sides.

All these arrangements represent a situation in which ownership of the capital is shared, rewards are addressed through a share in the outcome of the activity and material losses are shared in proportion to ownership stakes of the various partners along with labor going totally unrewarded. The ratio of sharing the outcome must be precise and set before the contract goes into effect.

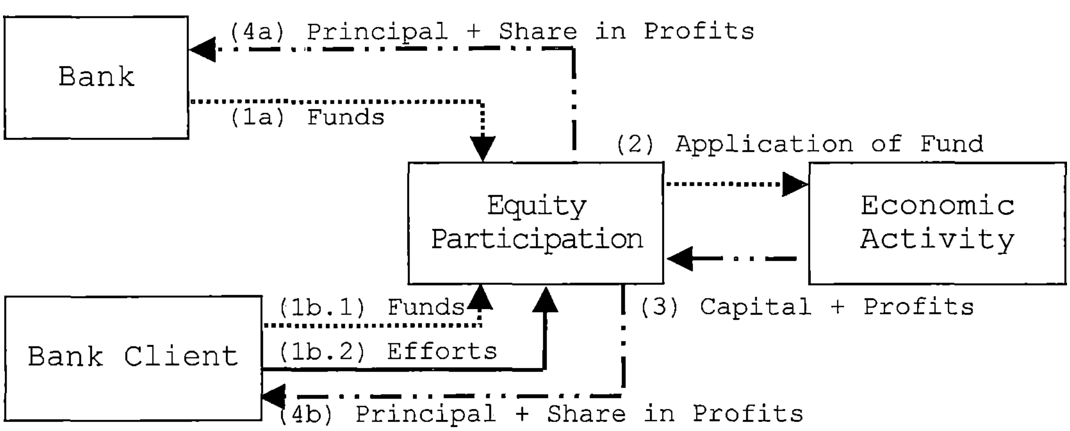
Bank client needs funds for undertaking economic activity trading (buying and selling, leasing, renting buildings and equipment)

Profit Sharing Bank:

A. Profit Sharing Financing Mode

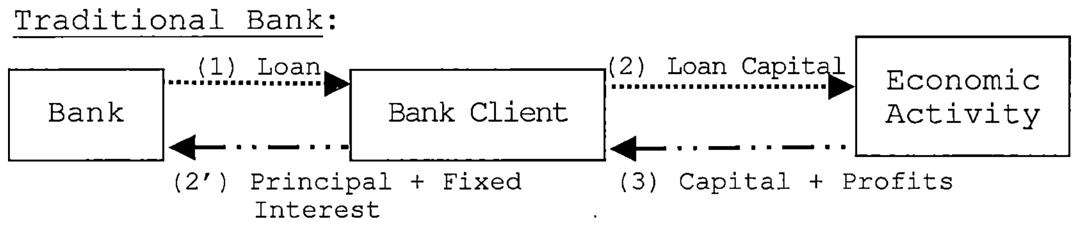


B. Equity participation financing mode



In case of loss:
(3) Would change into " Capital - loss"
(4a) Would change into " principal - share in loss"
(4b) Would change into " principal - share in loss"
- Bank is party to the use of funds - financing and economic activity are inseparable

Figure 4. Profit Sharing Bank Partnership



- There is a dichotomy between financing and the use of funds
- Payment claims in favor of the banks are independent of profit/loss to the client

Figure 5. Traditional Bank Partnership

Mobilization of Funds (Deposits) by Banks

The universal commercial banks, offer three types of deposits to their clients: demand deposits (current accounts), term/time deposits and general savings deposits.

The first type, demand deposits, carry no return but sometimes some privilege in the form of overdraft facilities. Banks offer interest on both fixed-term and savings deposit; however, the two differ in terms of the degree of flexibility in the withdrawal of funds and the level of rate of interest.

Current accounts and other deposits carry no return; are considered as interest free loan from the depositors to the banks. This will ensure safe paying back of the principal to the depositors, and at the same time, allow the banks to use the idle funds. The banks may offer maximum flexibility in the withdrawal of funds and might offer overdraft facilities on an interest free basis to the depositors.

The saving accounts and term deposits are deposits, carrying returns. For this reason both accounts should be replaced by partnership arrangements, profit sharing as well as equity participation, between the banks and the depositors.

Indeed, each accounts for the profit sharing financing mode, should be maintained separately from other accounts of the bank. At the end of the contract period, the bank should calculate the profits, keep its share and distribute the depositors' share among them on a proportional basis. This last point presumes that the share of each depositor in total profits would equal the fraction of his deposit in the total profit sharing funds multiplied by the overall profit-sharing ratio in favor of the depositors.

Banks may consider deposits on equity participation basis. Similarly, each accounts for equity participation financing mode, should be maintained separately from other accounts of the bank .In this second case, the bank commits a part of its equity and that would be an indication to the risk-averse depositors that mean the bank is serious about profitable application of the funds.

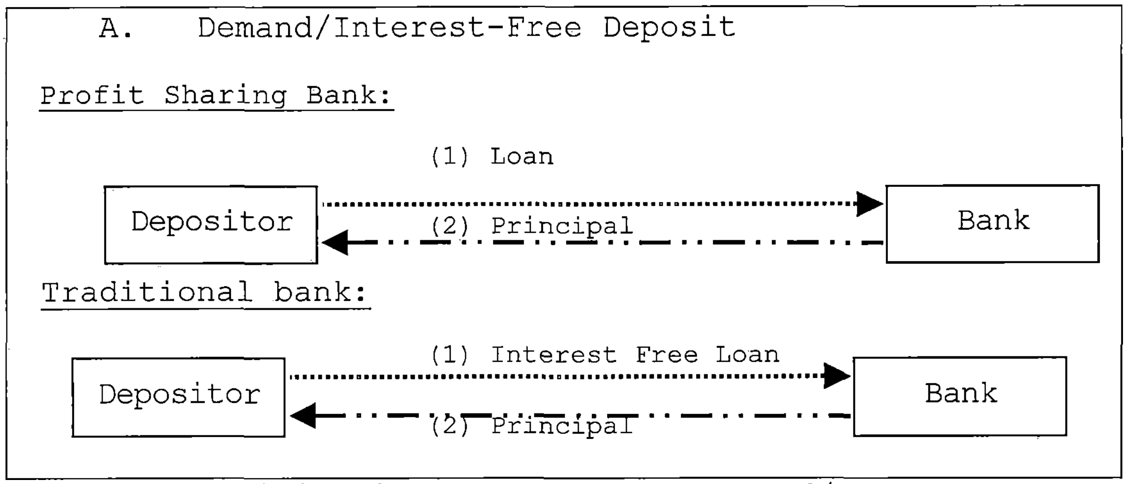
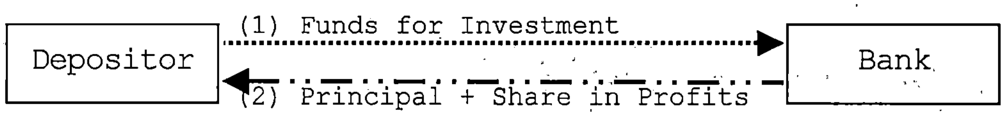


Figure 6. Mobilization of Funds for Demand/Interest-Free Deposit

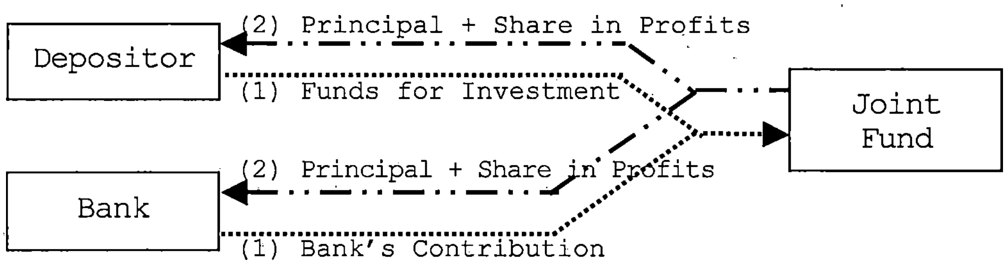
B. Deposit Carrying a Return

Profit sharing bank:

1. Profit sharing deposits



2. Equity participation deposits



Traditional bank:

Time/Investment Deposits

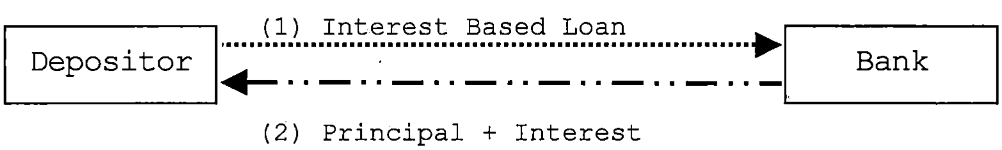


Figure 7. Mobilization of Funds for Deposit Carrying a Return

CHAPTER THREE

ATTEMPTS TO INTRODUCE THE INTEREST FREE CONCEPT TO THE WESTERN WORLD

Introduction

Interest free banking is a growing phenomenon, which came into existence to satisfy the financial needs of people who observe the prohibition of interest-based transactions and believe on it.

In this era, the age of integrated global financial markets, the instantaneous transformation of an entire financial sector based on interest to system based on profit-and-loss sharing, is very unlikely, but a successful presence of the interest free system, in the western counties, is still feasible: so how the interest free system can be implemented in a hyper competitive environment, the western market?

Flaws in the Current Western Economic and Financial System

Issam Tlemsani and Robin Matthews in their article "Ethical Banking: the Islamic View" presented some evidences on the failure of the current western economic system, happened in the last century, reflecting the threats and the weaknesses of this system:

> Khan (1986) has noted that the abolition of interest-based transactions is not a subject alien to Western economic thought. Fisher (1945), Simons (1948), and Friedman (1969) have argued that the current one-sided liability, interest-based financial system can be fundamentally unstable. There are many such examples; the German hyperinflation of the 1920s, post war hyperinflation's in South America, oil shock inflation's in Europe of the 1970s; and banking crises in Japan, East Asia, California, the BCCI debacle in the 1980s, and so on. The occurrence of crises is the result of a complex of factors emanating from over exuberance, greed underestimation of risk, overexposure, currency failures, asset depreciation, faulty regulation, macroeconomic shocks. (Tlemsani & Matthews, 2002)

Other point of views of the economist Saima Akbar Ahmed, reported in her article "global need for a new economic concept, 2001", claim on the failure of the current interest based system. She mentions that:" Never was the need for a new global economic thought more pronounced than it is today. Repeated failures of contemporary economics, sometimes manifested as Latin American economic crisis, sometimes appearing in the guise of South East Asian economic crisis and very recently, reaching the beginning of its climax in the form of very self-evident global economic crisis, have themselves made it imperative that all thinking and feeling individuals question its very bases and norms. In the west itself, as evident from the quote above, voices are being raised from many quarters against the flaws in the economic and financial system." She concludes her article by emphasizing on the fact that" The West has tried its hand at economics. The result is immense poverty amid affluence, not only in the poor countries, but also in the developed Western countries. Now it is the responsibility of the Muslims to contribute to a discipline on which their influence has largely remained dormant, with the obvious exceptions of a handful of individuals who have worked zealously to keep the discipline of Islamic economics alive."

Obviously, interest-based transactions that have been characterizing the Western banking models are behind many financial and economic crises. The idea to reform the world's economic and financial system seems doubtful, because the current economic and financial system itself is based on interest and certainly it will collapse if interest is removed from it. From this perspective, the profit sharing system was designed, to over come the weaknesses of the conventional system and to build an interest free society in today's times. It was created as an alternate method, on the basis of strong foundations and for the purpose of removing the harmful elements from the contemporary economic system

The Principles and the Tools of Interest Free Banking

Interest free banks, well known as a banking system that prohibits charging of interest in transactions, operate on the profit sharing basis under the Islamic law. This particular category of banks has moved from a theoretical concept to embrace more than 100 banks operating in 40 countries with multi-billion dollars deposits world-wide. The rules of these financial institutions are quite simple and can be summed up as follow:

- Any predetermined payment over and above the actual amount of principal is prohibited. According to the law of Islam, these banks allow only one kind of loan called: literally good loans, whereby the lender does not charge any interest or additional amount over the money lent.
- The lender must share in the profits or losses arising out of the enterprise for which the money was lent. The idea is to encourage people to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors. Islamic finance

is based on the belief that the provider of capital and the user of capital should equally share the risk of business ventures, whether those are industries, farms, service companies or simple trade deals. Translated into banking terms, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. This is unlike the interest- based commercial banking system, where all the pressure is on the borrower: he must pay back his loan, with the agreed interest, regardless of the success or failure of his venture. The principle, which thereby emerges, is that Islam encourages investments in order that the community may benefit. However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but rather content with hoarding money or depositing money in a bank in return for receiving an increase on these funds for no risk (other than the bank becoming insolvent). Accordingly, under Islamic law, either people invest with risk or suffer loss through devaluation by inflation by keeping their money idle. Islam encourages the notion of "higher risks and higher returns" and promotes it by leaving no other avenue available to investors. The objective is that high-risk investments provide a stimulus to the economy and encourage entrepreneurs to maximize their efforts.

- Making money from money is not islamically acceptable. Money is only a medium of exchange, a way of defining the value of a thing; it has no value in itself, and therefore should not be allowed to give rise to more money, via fixed interest payments, simply by being put in a bank or lent to someone else. The human effort, initiative, and risk involved in a productive venture are more important than the money used to finance it. Muslim jurists consider money as potential capital rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e. interest). Muslims are encouraged to purchase and are discouraged from keeping money idle so that, for instance, hoarding money is regarded as being unacceptable. In Islam, money represents purchasing power, which is considered to be the only proper use of money. This purchasing power (money) cannot be used to make more purchasing power (money) without undergoing the intermediate step of it being used for the purchase of goods and services.

- Uncertainty, Risk or Speculation is also prohibited. Under this prohibition any transaction entered into should be free from uncertainty, risk and speculation. Contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions. Also, parties cannot predetermine a guaranteed profit. This is based on the principle of 'uncertain gains', which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal, plus an amount to take into account inflation. The rationale behind the prohibition is the wish to protect the weak from exploitation. Therefore, options and futures are considered as un-Islamic and so are forward foreign exchange transactions because rates are determined by interest differentials.

- Investments should only support practices or products that are not forbidden -or even discouraged- by Islam. Trade in alcohol, for example would not be financed by an Islamic or interest free bank; a real-estate loan could not be made for the construction of a casino; and the bank could not lend money to other banks at interest.

Anatomy of Interest Free Banks

As mentioned earlier, Islam does not deny that capital, as a factor of production, deserves to be rewarded. Islam allows the owners of capital a share in a surplus, which is uncertain. To put it differently, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved. The owner of capital may invest by allowing an entrepreneur with ideas and expertise to use the capital for productive purposes and he may share the profits, if any, with the entrepreneur- borrower; losses, if any.

Another legitimate mode of financing recognized in Islam is one based on equity participation in which the partners use their capital jointly to generate a surplus. Profits or losses will be shared between the partners according to some agreed formula depending on the equity ratio. Both modes of financing constitute, at least in principle if not in practice, the twin pillars of Islamic banking. The equity participation principle is invoked in the equity structure of Islamic banks and is similar to the modern concepts of partnership and joint stock ownership. In so far as the depositors are concerned, an Islamic bank acts as a borrower, which manages the funds of the depositors to generate profits. The bank may in turn use the depositors' funds on a profit sharing basis in addition to other lawful modes of financing. The bank may also enter into equity participation contracts with the users of the funds, sharing profits and losses, as mentioned above. At the deposit end of the scale, Islamic banks normally operate three broad categories of account, mainly current, savings, and investment accounts. The current account, as in the case of conventional banks, gives no return to the depositors. It is essentially a safekeeping arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time and permits the bank to use the depositors' money. As in the case of conventional banks, check books are issued to the current account deposit holders and the Islamic banks provide the broad range of payment facilities - clearing mechanisms, bank drafts, bills of exchange, travelers checks, etc. More often than not, no service charges are made by the banks in this regard.

The savings account is also operated on a safekeeping basis, but the bank may at its absolute discretion pay the depositors a positive return periodically, depending on its own profitability. Such payment is considered lawful in Islam since it is not a condition for lending by the depositors to the bank, nor is it pre-determined. The savings account holders are issued with savings books and are allowed to withdraw their money as and when they please. The investment account is based on the profit sharing principle, and the deposits are term deposits, which cannot be withdrawn before maturity. The profit-sharing ratio varies from bank to bank and from time to time depending on supply and demand conditions. In theory, the rate of return could be positive or negative, but in practice the returns have always been positive and quite comparable to rates conventional banks offer on their term deposits.

At the investment portfolio end of the scale, Islamic banks employ a variety of instruments. The profit sharing and equity participation modes, referred to earlier, are supposedly the main conduits for the outflow of funds from the banks.

In practice, however, Islamic banks have shown a strong preference for other modes, which are less risky. The most commonly used mode of financing seems to be the 'mark-up' device, which is resale contract. In a resale contract transaction, the bank finances the purchase of a good or asset by buying it on behalf of its client and adding a mark-up before re-selling it to the client on a cost-plus basis. It may appear at first glance that the mark-up is just another term for interest as charged by conventional banks, interest thus being admitted through the back door. What makes the resale contract transaction Islamically legitimate is that the bank first acquires the asset and in the process it assumes certain risks between purchase and resale. The bank takes responsibility for the good before it is safely delivered to the client. The services rendered by the Islamic bank are therefore regarded as quite different from those of a conventional bank, which simply lends money to the client to buy the good.

Islamic banks have also been resorting to purchase and resale of properties on a deferred payment basis. It is considered lawful in Islamic jurisprudence to charge a higher price for a good if payments are to be made at a later date. According to Islamic jurisprudence, this does not amount to charging interest, since it is not a lending transaction but a trading one.

Leasing is also frequently practiced by Islamic banks. Under this mode, the banks would buy the equipment or machinery and lease it out to their clients who may opt to buy the items eventually, in which case the monthly payments will consist of two components, i.e., rental for the use of the equipment and installment towards the purchase price.

Reference must also be made to pre-paid purchase of goods, as a means used by Islamic banks to finance production. Here the price is paid at the time of the contract but the delivery would take place at a future date. This mode enables an entrepreneur to sell his output to the bank at a price determined in advance. Islamic banks, in keeping with modern times, have extended this facility to manufactures as well.

It is clear from the above explanation that Islamic banking goes beyond the pure financing activities of conventional banks. Islamic banks engage in equity financing and trade financing. By its very nature, Islamic banking is a risky business compared with conventional banking, for risk sharing forms the very basis of all Islamic financial transactions. To minimize risks, however, Islamic banks have established reserve funds out of past profits, which they can fall back on in the event of any major loss.

The Cost of Borrowing Model of Interest Free Bank

The usual interest charged by the conventional banks has been taken and split into six distinct components, the purpose of each component is determined, each is examined to see if it contained any element of the prohibited interest.

It has been shown that, of the six components only one is considered as prohibited interest and all the other five belong to the category of costs and remuneration. On account of this, the usual interest charged by conventional banks is called the cost of borrowing. Its six components are: interest paid to the depositor, cost of overheads, cost of services, a risk premium, profit (or remuneration to the bank), and compensation for the value loss of capital due to inflation.

1. Interest

In normal commercial banking practice, the funds used for lending are mainly derived through the savings deposits. The bank pays a certain percentage as interest to the depositors and recovers it from the borrowers when it lends. This interest is the first component in the model of the cost of borrowing. Of all the six components of the cost of borrowing only this component is received by (or paid to) the depositor, in addition to his capital (deposit). In the general case, this component is positive and is dependent on the interest rates the bank pays to its depositors.

In the case of a Muslim community, this component is considered as prohibited interest since any addition to the capital has been defined to be "interest". The implication is that the bank will not collect this component from the borrowers in order to pass it to the depositors.

2. Services cost

This is the cost involved in processing the application. This may include legal and other charges paid by the bank for services such as the evaluation of the collateral and checking its title, preparation of loan documents, postage, etc. This cost is specific to the concerned loan, and therefore need be borne entirely by the concerned applicant.

This is an actual cost incurred by the bank, and is independent of the size of the loan or the period of repayment. Therefore there should be no objection to it on grounds of any resemblance to interest.

3. Overheads cost

This goes to the maintenance of the bank, including staff salaries and office expenses. This is unavoidable, but it is also difficult to determine the exact amount used up by any given loan. Therefore a method has to be found to charge an average rate. What has been suggested is to compute the bank's average total running expenses per annum and divide it by the average total assets of the bank per annum, to obtain a per dollar per annum cost. Then this rate will be used to compute the overheads cost due from the borrower. It is not interest but a cost necessary to maintain the bank whose services the community, the depositors and the borrowers need.

4. Profit

The bank has a commercial concern, providing a service - carrying money from the lender to the borrower and back, keeping it safe, receiving from and paying to both the depositors and the borrowers, keeping accounts, buying and selling services from third parties. The costs of these are taken into account in the two preceding components. But how about a remuneration to the bank for arranging these services? Should it do it without any benefit to itself, investing its own money, time, expertise and effort? Is such remuneration is a prohibited interest? Obviously not. However, it may give rise to concerns depending on how it is computed. If it is computed as a percentage of the loan amount, there may be some room for doubts. But, here it is proposed to be computed as a percentage of the costs of the services the bank provides (i.e. the services and overheads components, seen above). Thus it is a legitimate remuneration or profit.

5. Risk premium

This is a collective insurance scheme designed to compensate the bank in case of defaults, and to discourage delays and encourage early settlements. The premium is proportional to the size of the loan. But good behaviour increases the credit rating of an individual borrower and decreases his premium rate, and vice versa.

6. Compensation for inflation

Inflation can comes in two different forms: the general inflation affecting the costs (second and third components), and currency depreciation affecting the value of capital. The first is unavoidable, inseparable and legitimate. But the second is value erosion of capital; in fact, in fairness to the capital holders this loss must be compensated, so that their capital is not eroded due to no fault of their own. This component is the amount that needs to be paid to the capital holders (depositors) in order to restore their capital to its original value.

Towards Interest Free Mortgage Financing in Western Countries

The instinct of owning a place to live in and to produce livelihood has produced a natural dream for every individual and family. That is why the backbone of the major developed countries and societies has been the housing industry. In addition, in these countries, such as England, Germany and the USA, the development of mortgage financing has helped propel the economies directly and indirectly: Directly by increasing demand for the products, industries and services associated with buildings and homes, and indirectly by satisfying the natural instinct of ownership in the citizen.

The ultimate need of housing and the diversity of mortgage industry as well as the financing method's availability in many different credit institutions, make this particular industry a good example, to judge the effectiveness and the degree of success of such profit sharing system. Indeed, housing finance is one of the interest free bank's products and the western countries, become nowadays, their target segment market.

The potential opportunities of the interest free system and the idea to enter a hyper competitive market should be analyzed and diagnosed at a detailed level.

For this purpose, the US market, is selected to be an ideal framework for the analysis.

In the United States, a number of institutions were developed to act as a catalyst in the promotion and facilitation of owning a home. "Examples are:

- Federal National Mortgage: was designed to provide ongoing assistance to the secondary market for residential mortgages by providing liquidity for residential mortgage investments, thereby improving the distribution of investment capital available for such mortgage financing.

- Federal Loan Home: was chartered by the US Congress in 1970 to create a continuous flow of funds to mortgage lenders in support of home ownership and rental housing. The company purchases first lien, conventional, residential mortgages, including both whole loans and participation interests in such mortgages.
- Government National Mortgage Association or GNMA: provides pass through certificates which have an interest in a pool of single family home mortgages that are insured by the Federal Housing Administration (FHA) or by the Veteran's Administration (VA)

In fact one of the important parameters used by the Federal Reserve System (FED), in its decision regarding interest rate and monetary policy, is the its impact on the housing industry.

Moreover, the US government, in an effort to encourage Americans to own homes through mortgage financing, has made interest paid through mortgage financing tax deductible. It is now one of the few deductions left to the average citizen that helps in reducing taxes". (Towards ALARIBA mortgage financing in the United States providing an alternatives to traditional mortgage 1999)

The different institutions of promotion and facilitation of owning home, the government regulation concerning the tax deduction on interest paid through mortgage financing, and many others factors, together, make the US market, a hyper competitive market. Do the interest free housing finance, has chance to enter it?

Home Mortgages in the United States

"Approximately 66% of the residential properties in the United States are owner occupied. They represent about $7,000 billion in value. Mortgage payment is the biggest monthly liability of a typical American household.

Typical homebuyer borrows up to 85 to 90% of the purchase price of a home. A typical mortgage has a 30-year term. Because of the mobility of the US employment market and the continued needs of American families to move to larger and more modern homes in more attractive suburbs and neighborhoods, many of these mortgages are closed way before the end of 30 years. California Home Financing Association 1996 statistics on the characteristics of homebuyers and sellers in California indicate that the average number of years of owning a home is approximately

8 years. As the homeowner moves to another home, he/she closes the old mortgage, pays off the loan and applies for a new home mortgage". (Towards ALARIBA mortgage financing in the United States providing an alternatives to traditional mortgage, 1999.)

Interest Free Mortgages: The Market and the Potential Customers

The first target customers, of interest free mortgage are the Muslim population in the United States, which ranges between 5to 8 million or at least a portion of it, since they are mainly concerned with the prohibition in the use of interest based on the Islamic religion.

The potential customers include also many other people in the US, who feel disenfranchised by traditional methods of financing, or who feel that they do not have adequate access to credit, or that the terms of the credit that is available to them are morally objectionable or economically unfeasible for them, many of whom simply cannot afford traditional bank accounts because they live from paycheck to paycheck and cannot maintain a minimum balance.

These target customers, have in most cases, reasonable cash savings but not enough to buy a home. Their balance sheets are clean of any debt under the assumption that they refused to deal with interest under any circumstance.

In order to satisfy this community's natural instinct of owning a house, it would be a challenging opportunity for interest free bankers and investment/mortgage bankers to enter the US market and to cater the needs of those people.

As the concept gains credibility and proven track record, it is expected that the concept of interest free mortgages will grow significantly to attract members of other social classes, who will like the concept as well as the new generation of youths who are more sophisticated in evaluating alternative mortgage concepts.

<u>The Interest Free Lease Purchase Model</u>

The model is too simple and straightforward. It consists of two parts:

- The first is the return of capital.

  Example: If the house price is \$180,000, the client pays \$60,000 and the balance is financed by profit sharing bank. In this case the client owns 33.4% of the house and the bank owns 66.6% of the house.

  The client agrees to buy back the share of interest free bank over a period of 5 years in monthly installments of $2,000 per month. The title of the house is transferred directly to the client to minimize costs and taxes.

Interest free bank becomes the lien holder. The client owns the house and handles his/her property in terms of maintenance, upkeep and renovation in the same way a traditional mortgage holder would.

- The second part is the lease of the house.

  The client agrees to lease the house for a period of 60 months; the term of the pay back. The lease is estimated based on comparable lease rates of houses in the neighborhood and is negotiated on an ad-hoc basis between the client and the interest free institution.

  The lease income is distributed between the client and his bank. The client's portion of the lease is used in the computer model to expedite the buy back process.

Strategic Alternatives for Effectively Targeting the US Market

A strategy is the art and wisdom of matching the goals with the available resources in light of the social, business and political environment people live in.

The following is a summary of a proposed strategy:

- The Need For Grassroots Community Involvement:

  The primary market segment for interest free mortgages is large by the American Muslim community's humble means. Interest free banking and financing system does not have a proven track record in the United States and the idea to implement the new system in the US, is still in its introduction stage. For that reason, relying on the local resources is a must, which means relying on localized grassroots community effort at every community center in the whole US. Adding to that, the interest free system should encompass both the flexibility and the foresight in order to compete in the market.

- The Laws of the US:

  From a strategic point of view, the banking and finances laws of the United States does not fit the interest free bank regulations as they are established in the Middle East.

  In contrast dealing with banking and financing matters in the United States; eventually will strict adherences to the letter of the law is required. Indeed, "many components of the American system represent years of human experience that cannot be thrown away. The Community Re-investment Act (CRA), the laws against usury, the equal lending opportunity laws, the Securities and Exchange Commission rules and regulations, the regulatory functions of the US banking regulators and the laws regarding full and complete disclosures are laws and regulations that reinforce basic human and Islamic values". (Towards ALARIBA mortgage financing in the United States providing an alternatives to traditional mortgage, 1999.)

Furthermore, the American financial, monetary and banking system is the most sophisticated and reliable in the world. For this reason, the efforts of interest free bankers should concentrate on providing an alternative not a substitute to that system. The reliability of that alternative system is in fact enhanced by the already tried and proven regulatory and legal system of America.

- Matching The Competition:

It is the interest free baking system's responsibility to provide a product that competes in the free market place equally if not better than the traditional mortgage. Title and ownership should be given to the buyer and not delayed. Implied mortgage rates should be disclosed and explained in comparison to the market. Monthly payments should be within the ability of the customer and in light of the monthly apartment or house rent they are paying. The administration and processing fees incurred in an interest free contract should be explained and compared to the "points" charged by traditional mortgages. Capital gains realized from the sale of the property before the expiration of the term should be competitive with the traditional mortgage.

- Marketing Approach:

Marketing of interest free services in general and mortgages in particular, should not follow the traditional "marketing hypes". It is a specialized product, at least at this stage of its product life, aimed to meet the needs of the target community.

Using expensive media campaigns and other mediums is extremely expensive and may attract unqualified applicants, who may take advantage of the general guidelines of interest free financing, which does not believe in a time value for money. "There is no substitute for a real grassroots effort of belonging to the community, knowing its members well and participating in its activities. That is why the interest free system, should focus on serving local communities in order to achieve the real meanings of "know your client", "community reinvestment" and touching the lives of each household in the community". (Towards ALARIBA mortgage financing in the United States providing an alternatives to traditional mortgage, 1999.)

This approach allows the profit sharing bank's officers to perform a better due diligence and it will reduce cost as the percentage of no performing loans becomes essentially negligible. In its effort to promote the concept, the interest free mortgage organizations should rely on personal contacts, recommendations of the leaders and active members of the community and of course all the required due diligence tools of credit checking, salary confirmation, references, tax returns and financial statements. The credibility of the system is enhanced and deepened by performing excellent due diligence. As a result the major source of business becomes referrals and word of mouth about real experiences as compared to the traditional "marketing hype."

- General and Administrative Expenses and Other Costs:

The success of the interest free system in its infancy depends on a voluntary approach in which professional bankers, financing officers and entrepreneurs, who believe in the system, offer their expertise and services on a voluntary basis. This will reduce cost drastically. In fact if they cannot afford working for free, they will be content with a salary that is much lower than what the competition offers. It becomes a mission and not a job. Another important byproduct is the sever reduction in non-performing loans.

* Education:

Educating the public using simple and understandable language about the interest free and traditional mortgage facts is a must. For example, the fact that a 30-year mortgage is seldom kept to maturity due to the fact that the average American family replaces it with another once every 5 to 8 years. This is due to job mobility, the growth of the family, the growth in income and the proximity to school. The fact of not making an impact on the principal of the loan in a traditional mortgage should be publicized. Education is also needed to explain that paying rent to oneself is equal to investing in ourselves, tax free, and realizing a return that is competitive with the average return on stock market investments. Familiarization with the mortgage schedules and the time value of money used in traditional mortgages are needed for many that are doing it to "go with the flow." The value of saving money for the children in a trust account to save for a sizeable down payment for their future home as they grow up and get married should be made understood by the community. These investments can be used to finance the mortgages of today and benefit the generations of the future. All these will bind the community together, increase mutual trust and help in the economic development of the community. This education will help bring the real spirit of the Community Redevelopment Act (CRA) to life.

Conclusions

The interest free financing system is potentially in harmony with the best of American virtue and values. It offers many benefits for civil society and community in a world where many are excluded from credit and finance.

Interest free mortgage financing is feasible in the USA if done strategically to satisfy the laws of Islam and those of the USA.

Involvement with the community on the grassroots level provides the safest way to finance and put in effect the "know your client" rule.

Long term (15 or 30 year mortgages) may offer the buyer an easy monthly payment but it also indirectly enhances the clients going deeper in debt. It is the responsibility of the sharing profit banker to rid people of debt in order to live freely.

The interest free model helps pay off the debt faster. It is the most suitable in the American mobile society that changes residences or refinances once every 5 to 8 years.

Interest free mortgages and financing brings real life into the Community Reinvestment Act stipulated by the American banking regulations.

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