The "Qard Hassan" Bank

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الحمد لله والصلاة والسلام على نبيا محمد وعلى آله وصحبه وسلم وبعد :-

Introduction:

Financial intermediation is essential to the growth and welfare of every society. Islamic societies are no exception. Like most other societies, Muslims did have arrangements to route savings to useful uses in commerce and investment. Nevertheless, they only knew banks during colonialism. Then they also became conscious of the fact that the western model of financial intermediation (which is interest based) is contrary to Shari'ah because it is usurious. Hence they came up with an alternative model which they called "Islamic Bank". An Islamic bank is an institution rendering financial intermediation not on the basis of lender-borrower relationship, but through the use of sale and partnership arrangements in both assets and liability sides of the balance sheet. This is because usury in banking appears mainly in interest based lending which are replaced here by Murabaha, Istisna'a, and Mudarabah… etc.

This model of banking is economically feasible and in line with the Shari'ah injunctions concerning financial transactions. However, it remains that an Islamic banking institution is merely a formal substitute for the Riba ridden conventional model. This is no accident as it was originally designed to be so. This meant that the reference point, measure and bench-mark of success of this model of Islamic bank has always been its ability to "substitute" the conventional model. Furthermore, the course of development of this Islamic model has been, over the last 3 decades, simply to emulate the conventional model, and to design products and services that basically have the same "economics" while "legally" Shari'ah acceptable. This is not surprising, because, again, the model was created to be a replacement for the conventional model.

A question is posed: had the Islamic civilization been alive and well, capable of internally producing solutions to problems independent from the pressure of foreign powers or other more dynamic civilizations. Had this be the case, would the Islamic model of financial intermediation been the same? In other words, what is the natural and self propelling progression of the internal dynamics of an Islamic society (when faced with the need for an institution for financial intermediation) would have produced?

We believe the response would have been different. These dynamics would have produced different forms of institutions. Unlike the capitalist model, the Islamic bank would have internationalized in its own development and design exalting justice, equity and social peace, values that are at the core of the Islamic system. The institution of financial intermediation should have descended from and Islamic root had Islamic civilization entered modern time free from western dominance. We believe that root is the concept of partnership and the great institution of Qard Hassan. At this point we have to free ourselves from the preconceived structure of modern banking and try to stimulate an imaginary course of development for an Islamic society.

What is Qard Hassan?

Qard Hassan is an Arabic term meaning a benevolent loan. In the jargon of Islamic finance, Qard Hassan (QH) refers to lending money without interest. The QH is regarded as an act of altruism and compassion. In one narration from the prophet PBUH, it is stated that the reward for QH surpass even that of *Sadaqa*.

For centuries, QH was quite widespread in Islamic societies and was considered one important means of finance and measure of Takaful and social solidarity. While it is difficult to substantiate without formal research, it is the feeling of the writer that no other civilization has given QH a prominent position like Islam. Lending was known in every society. But it has always been interest based.

An overview of the Islamic Economic system:

The term Islamic economic system refers to the injunctions in Shari'ah that organize the economic aspects of the individual and community life to create an Islamic setting for economic activities. As such tenets and injunction are absorbed by individuals, they produce an economic behavior that is conducive to the reproduction of that economic setting. The economic system also sets the limits of what is considered socially and Islamically desirable. For example, it is a well known fact that justice and social peace are two of the most important aspects of the social manifest of Islam. One can trace most of the Shari'ah orders to these two objectives. The Quran states very clearly that the prohibition of usury is because it is unjust. Furthermore, jurists are in agreement that one of the most important objectives of the prohibition of Gharar is the fact that it creates animosity between Muslims and hence exchange contracts with Gharar do not belong to this system.

The Islamic economics system consists of three main components working together in tandem to produce the social setting that is Islamically desirable. The public sector which consists of government institutions, the private sector which include for-profit economic activities, and the non-profit altruistic sector, mainly Waqf.

At the height of the Islamic civilization, the latter played a cardinal role in providing for services that neither the public nor the private sector attended to. Such as education and healthcare. For the public sector such provision requires taxation which were undesirable. Since the contractual basis upon which such services may be provided suffers from what economists call a-symmetry of information between the seller and buyer. It was not suitable for the private sector. The role of Waqf in the provision of education and healthcare in the old Islamic societies is well documented. However, the interesting thing is the fact that the institution of Waqf was expanding into other activities where, again, both public and for profit private sector are not suitable. This is exhibited by a well documented phenomenon in the 16th century Ottoman Empire which was called cash Waqf as well as other source similar projects in Muslim North Africa around the same time. It is sad that such trends almost disappeared 2 centuries later. As western colonization of most of Muslim countries was complete, it subdued the world of Islam and retarded this process. This is because Waqf was particularly targeted by the carnage of the colonists because it was a source of independence of the people from reliance on the foreign rulers and was always suspect of helping antagonists.

The macro structure of an Islamic Economy:

From a macro perspective, modern economies are divided into two main sectors: the real sector where production of real goods and services takes place and the financial sector where mainly financial risks are taken. When these two sector function in tandem, the economy works well producing the desired rate of growth. It remains however, that each sector have its own "dynamics" which may cause diversion from the desired path. The "trick" for policy makers and regulators is to align these two sectors together. If policy fails, a gap arises and a dichotomy between the two sectors will be created. The economy then suffers from either inflation or recession. What causes this "gap" is the nature of the capitalist system. Although finance is suppose to be "a leg up" to the real activity, interest based transactions creates financial products that behaves like real ones. This is because demand for monetary assets is, like everything else is dependent on the price. However, once you have interest based financial transaction is determined in the money (debt) market independent from the real sector. Hence, return generated by holding monetary assets and return generated by holding real assets may not be in tandem except by coincidence.

Two of the most important aspects of the Islamic economic system is the prohibition of usury[1] and the principle that financial obligations (i.e. debt created by deferred payment sale or benevolent loans) remain at face value and are not permitted to be sold or traded in the open market. This meant that both the real sector and the financial sector are cemented together and essentially have the same dynamics. Rate of return generated by holding real assets constitutes the fundamental determinate of demand for both real and monetary assets. These rates of return are represented by the average rate of profit or the yield of holding securities which represent a claim on real assets (in production or exchange). This rate must be high enough to induce wealth owners to hold such assets at this current price. However, in the capitalist system an alternative exists in the form of holding financial assets such as debt instruments. Instability is induced when holders of financial assets make more risk adjusted return than those who hold equity. Unless real assets generate higher risk

[1] Usury and Riba in Islamic jurisprudence refers to two conceptions: Riba in sales, (something called Riba of Sunnah for it was not mentioned in Quran) it relates to transactions involving six commodities prime among which is gold and silver. The contemporary application of this Hadith is to do with exchange of currencies where it is a requirement that no delay in exchanging one money for another (and an exchange involving the same currency has to be at par).
The more important is the concept of Riba Al-Dyon, i.e. usury in debt it …. When an increase is stipulated in a loan contract, or an extension of the term monetary obligation (debt) for money. Clearly this depicts exactly the modern concept of interest. Therefore it has been the view of contemporary Shari'ah scholars that interest as defined in modern finance is Riba. Prohibition of Riba Al-Dyon is affirmed in the Quran and Sunnah.

adjusted return than the pure financial assets, they will not he held by wealth owners. In an Islamic economic system, these pure financial assets are not an alternative simply because they do not exist. Therefore, every transaction is effectively a real one. A stable and more equity oriented economy is created.

The proposed structure:

We should start by a disclaimer. Our proposed structure is not a panacea which will solve all the problems. Nor that it is a substitute for the current model. Rather it is a supplement to a strong capital market and partnership based financial arrangements. But it is a first step in building an Islamic economic system. We are proposing a new institution called "the Qard Hassan bank" (QHB) which in our view is more compatible with the character of the Islamic economic system and more in line with what we think is the natural progression of the Islamic society. The purpose of this financial intermediary to transform a consumer lending into a cooperative enterprise. The idea is to establish a non-profit financial intermediary specializing in consumer lending on the basis of Qard Hassan.

Firstly: A Waqf[2] is established through the donations of few wealthy Muslims. This would be a monetary Waqf. The purpose is to establish the capital of this institution. Hence, the Waqf will constitute a base of around 2-4% of the total assets managed by the said institution. As we know, the function of capital of financial intermediaries (commercial bank) is to work as a cushion to protect the integrity of the institution against shocks. The Waqf deed should state clearly the purpose of the same and it should also define the beneficiaries of the return on capital that might be generated. There is no problem in stipulating that parts of such returns are used as reserves to augment the capital. The rest may be donated to charitable purpose. Such return will not come from the lending transactions but from other investments like foreign currency account or interest in real estates.

a) The institution will then receive deposits. These would be both current accounts and time deposits. No interest is paid on either. For the current account it is not difficult to see why people would opt for the QH bank. Assuming that risk is similar, a current

[2] The *Waqf* is different from *Sadaqah* in that it can be directed towards any non-*haram* activity and need not be only for the poor and the needy. The only thing that is not allowed to the establishment of a *Waqf* solely for the rich.

account in our bank will be similar to any other bank. All the standard services received by current account holders in conventional banks would also be available here such as chicks, ATM cards, and money transfer.

Why would someone opens a time deposit account if such account pays no interest. Since the institution is basically a benevolent one, drawing upon one's Islamic spirit and love for cooperation and arousing in Muslims the desire to increase solidarity and Takaful, it is not unlikely that many will respond to this call by actually allowing their funds to be "parked" for a specific term in the institution. In other words, blocking an amount of deposit in their current account for a specified length of time. This can be on the basis of temporary Waqf.
Sources of funds for the QR bank will be capital plus current and time deposits.

c) This institution will then provide short and medium (and may be long) term loans to individuals. They will all be interest free. However, they are not nominal for the borrower would also have to carry the cost of providing such loans. This basically covers actual administrative expenses. No "opportunity cost" is accounted for. Such increment on the loan is not considered Riba (A considerable portion of IDB's finance is on the basis of interest free loans which do carry the actual administrative expenses).

d) This institution will apply the most modern procedures for credit scoring and risk analysis to make sure that loans will be repaid on a timely fashion. Only those who are credit worthy would get loans. Now credit worthiness is not necessarily "richness" or "wealth ness". Rather, it is being able to pay back dues. Hence, this institution will not be confined to only high net worth individuals. The wealth may influence the size of the loan but not the decision to lend.

e) The institution will not be confined to straight lending. It can also engage in issuance of credit cards. It can also issue letter of guarantee and many other Shari'ah permissible banking services.

f) All in all, this institution will operate just like a commercial bank except for two aspects:

    a. That it has no profit seeking shareholders. This is because it is based on Waqf.

    b. Generates no interest income.

Corporate governance aspects

In a standard conventional commercial bank, the management of the institution answers to shareholders. Those shareholders seek maximum return on their investment. Hence, in the day to day operation of the bank, the management is always after the "best" allocation available for the banks financial reserves. This "best" allocation is characterized by a relentless effort to maximize the difference between cost of funds and income generated from lending. In this equation the interest of both depositors (sources of funds) and borrowers (users of funds) comes secondary to the interest of shareholders. In countries where competition between banks is not forceful enough, we find that banks actually pay the lowest interest on deposits and charge exorbitant interest on loans.

In the model we are proposing there is no conflict of interest between management and the sources and users of funds. This is because the legal structure is Waqf. Management is salaried individuals, whose basic objective is to render good service, and may give some attention to the growth and expansion of the institution.

Operational Issues:

1) The targeted segment of societies.

The middle class constitutes the largest portion of most modern societies. Islamic societies are certainly no exception. The middle class is the source of savings and clearly the engine of consumption. We can conceptualize that the proposed institution is a redistribution vehicle within the middle class. This is because most of the funds will essentially come from the middle class and go to the middle class. Those who are amongst the wealthy may find their own sources of funds for consumption purposes and certainly can draw capital for investment purpose through other institutions such as capital market or direct partnership.

As for the poor segment of this society, they will not be completely outside the scope of the operation of this bank. However, only those who maintain a regular income may get loans. Those who don’t will find Zakah as more suitable source for their consumptive needs.

2) Procedures for credit extension:

This bank will only advance loans on the basis of credit worthiness of the client. Therefore, it will apply the most stringent process of credit analysis. Only those who are reputable and maintain good record may benefit from this institution. Furthermore, this bank would also apply a collection procedures aimed at reducing bad loans to minimum. While the institution is basically a Waqf, and part of the benevolence sector of the Islamic economy, this is no reason for it to be lax when it comes to maintaining the financial integrity of the institution or lenient with delinquent borrowers. This bank can also benefit from the contemporary concept of penalties in Islamic banking. These penalties are imposed for the purpose of deterring potential defaulters. They basically work as a "threat" and hence improve the risk profile of the lending operations. The proceeds may be donated to charity so that they are not considered Riba.

3- Risk to depositors:

Depositors are the main source of funds for this institution. While we assume that individuals will be attracted to this bank because of their desire to do good to themselves and their fellow Muslims and to participate in this Takaful project, it remains that they will no do that if it means they would face higher risk than what is considered normal for a bank deposit.

The good news is that they need not. There is no reason to believe that these deposits will be more risky than the alternative. As we know the depositor actually takes the risk of the bank. He hopes that the bank management is experienced enough not to make more losses than can be covered by the capital of the bank. If they did, he would then lose his deposits. Otherwise, he can still receive back his savings. In almost all countries governmental arrangements for deposit insurance (or an equivalent of that) are in place to further protect these deposits. It would be the same here. If management succeeded in limiting possible loss to capital, then depositors can receive back funds. There is no reason to believe a deposit insurance arrangement will not also cover this bank.

Liability:-

1- Checkable deposits:

These are similar to what is usually called checking account in conventional banking. Withdrawal and transfer to third parties are usually done by check. ATM cards and phone banking can also be used.

Although it differs from one country to another, checkable deposits contribute around 1/3 of bank deposits (P. 141, Commercial Banking, Reed & Gill).

A checking account in the QHB is no different from that of any other commercial bank. Here the bank easily fit into the system utilizing the regular clearing and collection system in central bank.

2- Temporary Waqf account

The QHB will have another important source of funds, which the temporary Waqf accounts. These accounts are not dissimilar to standard time deposits except for the fact that no return is paid to the account holder. People participate out of benevolence and philanthropic disposition. When one has extra cash he can do without for a few months, it can be deposited in these accounts, where other fellow Muslims (or non-Muslims) can benefit from. One more difference as compared to time deposits, is the fact that these temporary *Waqfs* do not create a borrower-lender relationship. Only in case of negligence or mismanagement they could be guaranteed by QHB.

QHB Assets:

The QHB assets may consist of the following items:

1- Cash in the vault.
2- Loans extended to consumers. This will construe the bulk of the asset side of the balance sheet.
3- Bank premises and fixed assets.
4- Other tangible and intangible assets.

Clearly, the QHB is quite similar to any commercial bank. This means that the same accounting and auditing standards can be utilized and the supervision of the bank regulations will not be a formidable task.

QHB Fund allocation:

The process of fund allocation may not be dissimilar to any regular commercial bank. Funds are allocated as follows:

A- Reserves.

1- Legal reserves:

Reserve requirements are imposed on all depository institutions by law. These reserves are either vault cash or deposit balances with central bank. Legal reserves are applied to demand deposits and other accounts which the account holder is permitted to make withdrawals by order. The purpose of these reserves is to enhance the ability of central bank to manage monetary poling.

2- Secondary reserves:

Some of the funds received by the QHB are essentially *Waqf* that can be invested for the benefit of the institution. These temporary cash *Waqfs* will have a maturity and therefore the temporary cash *Waqf* portfolio would also have to be supported by reserves. These can be in the form of highly liquid assets which generate income.

B- Loan Portfolio:

The QHB will only lend natural persons for consumption purposes. These can be restricted to a limited user such as education, auto and credit-card type finance.

Macro effect of the QHB:

a) Money Creation:

One of the major functions of banks is ability to create money. The bank sector ability to create money is of great economic significance. Without bank credit, economic expansion may not be possible. When money supply lags, economy may suffer deflation. Hence bank role in increasing money supply is important.

The QHB will have the same ability to create money. This is because the mechanism through which money is created in the banking system remains intact. Whether the QHB is only a participant in the regular banking sector or a major portion of that system the function of money creation will remain.

Truly interest free consumer lending:

Because we do not foresee the QHB to go beyond consumer lending, our discourse of its macro effect will be confined to this sector.

The QHB operations are truly interest free. The non-interest financial operations of Islamic banks are only legally interest-free from an economic point of view, the effect of interest rate remains very profound on the supply and demand of loanable funds. In the QHB model, the price which clears the loanable funds market is simply the administrative cost of the QHB operations. This "price" behaves differently from interest rates, for it would not change in the same manner.

This does not mean, however, that the QHB will be insulated from the market fervor. In times of weak economic activities, funds available to the QHB will most probably be relatively low reducing its ability to create an increase in consumer demand by lending more money.