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Volker Nienhaus

Profitability of Islamic PLS Banks Comparing with Interest Banks, Vol. I: 1

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Dr. Nienhaus notes that whereas the bulk of the literature on Islamic interest-free banking assumes an economy from which interest has been completely abolished, existing Islamic banks have actually to operate in an interest-based system in competition with interest-based banks. This being the case, the above-mentioned literature `hardly can help to describe and analyse the situation, problems and prospects' of these banks. Then he notes the `ambitious anticipations' of the advocates of Islamic banking who hope that "the Islamic banks will turn out to be so successful in economic terms, i.e., so profitable for capital owners as well as depositors and without any adverse (but a number of beneficial) effects for the funds demanding entrepreneurial partners of the banks, that (in the long run) everybody will turn away from interest banks and towards Islamic banks".

Assuming that Islamic banks will operate only on profit-sharing basis and ignoring such operations as leasing and mark-up in which the existing Islamic banks are actually involved, Nienhaus proceeds to demonstrate that competition with interest banks will result in a pressure on the profitability of Islamic banks and should cause these banks to think about some innovative strategies for productive and profitable employment of funds. Under present market conditions dominated by conventional banks Islamic banks can not neglect the market rate of interest but must base their calculations on it, he thinks. Assuming that everybody wants to maximise profits, Nienhaus demonstrates with the help of a simple model that "for a given profitability of the entrepreneur's project and a given amount of needed capital the bankers ratio of profit-sharing (brp) will increase when the interest-rate rises and decrease when it falls, so that the profits accruing to the entrepreneur under the profit-sharing arrangement are the same as in the interest-based arrangements. It follows that "the Islamic bank's' revenues from profit-sharing financing would not exceed the revenue of an average interest bank out of its interest loan business". (p.7).

The above conclusion was based not only on the assumption that banks and entrepreneurs have the same profit expectations (both in case of interest-based lending and profit-sharing advances) but that these expectations are fully realised. Abandoning this assumption and allowing realised profits to be different from expected profits, the writer concludes that in case actual profits are less than those expected, Islamic banks will receive less than they expected. Had it been known to them, they would have opted for a higher brp. Since there will always be the risk that actual profits are less than those expected by the entrepreneur, the Islamic banks will adopt a conservative attitude towards entrepreneurial estimates about profits, always basing their calculations of the appropriate brp on a lower estimate. This, Nienhaus thinks, will prompt the entrepreneurs to inflate their profit expectations. (Where does this stop?). To compensate for this `disadvantage' Nienhaus visualises the Islamic banks becoming super entrepreneurs themselves, specialising in certain areas of investment so that they can themselves explore and assess opportunities of profitable placement of funds instead of passively waiting for entrepreneurs to approach them and then relying on their profit expectations. He concludes that in a `capitalistic' world Islamic banks will become a kind of merchant banks instead of universal commercial banks.

Nienhaus then proceeds to suggest that Islamic banks may profitably invest in transfer of technology to domestic (Muslim) economies and get involved in the process of their development.

I think that the author is right in noting the fact that real world Islamic banks are to operate in competition with interest banks hence the old literature is not sufficient for their study, some new elements must be introduced. This he does, arriving at conclusions that are not much off the mark. I have only two serious flaws to point out, besides questioning an assertion by the author, which he fails to support by citing proper evidence.

(1) It is a well known fact that the inception of Islamic banks in interest dominated societies owes itself to the existence of a group of people determined to avoid dealing on the basis of interest. This group is surrounded by another group of people who would prefer dealing without interest provided it does not involve them in appreciable disadvantages. Then there is the common humanity - Muslim and non-Muslims - who are indifferent. Dr. Nienhaus is ignoring the first two groups both among depositors and entrepreneurs. His universe of profit maximisers comprises people indifferent between interest and profit-sharing. But how would he explain the emergence of profit-sharing banks in such a universe'?

A more realistic approach would be to take into account people who wish to maximise profits subject to the constraint that they would not deal with interest, and profit maximisers who would not deal with interest provided the disadvantages do not threaten their survival (as wealth owners or entrepreneurs). This will not alter the main conclusions of Nienhaus' model but it will decrease the disadvantage from which the Islamic profit-sharing banks suffer in his model. This has its implications for the main thesis that Islamic banks will be less rather than more successful than the interest banks.

(2) Nienhaus thinks there will be a tendency on the part of entrepreneur to exaggerate the profit prospects of their projects which, in turn, will make the banks introduce a reduction in these estimates when calculating the brp. This would cause entrepreneurs to make further exaggeration leading to further reduction by banks. This game obviously can not continue adinfinitum as both parties will soon realise the futility of doing so. The only sane attitude, and safe assumption to make, is that entrepreneurs present correct estimates and banks examine them in the light of reports from their own experts. The brp is ultimately settled on the basis of some estimate shared by both. Again, this is not going drastically to change the results of Nienhaus' model, but it does reduce the pressure on Islamic banks to transform themselves into `merchant' banks.

Nienhaus says that advocates of Islamic banking predict higher profitability for the customers of Islamic banks, as compared to interest banks, so that `everybody will turn away from interest banks' to them and there will be an evolutionary change from interest banking to Islamic banking throughout the system. But he cites no evidence as to who among the advocates of Islamic banking made such a claim. We are not aware of such an unqualified claim being made. He should better check his source. Any claim regarding the superiority of the profit-sharing system, hence of its capacity to initiate an evolutionary change in its favour, are based not on the micro-economic consideration of greater profitability but on the macro-economic grounds of justice, allocative efficiency and stability of the new system.

Comments: Ziauddin Ahmad, Deputy Governor, State Bank of Pakistan

The article "Profitability of Islamic PLS Banks Competing with Interest Banks: Problems and Issues" by Dr. Volker Nienhaus is largely a pedagogic exercise in certain aspects of Islamic banking. Like most pedagogic exercises, it has a certain value in lending some rigour to thinking on the subject. However, as far as the main thrust of the article is concerned, the author makes a number of unwarranted assumptions in consequence of which, the conclusions he reaches are, of rather doubtful validity.

The main thesis of the article is that: "There are good reasons to believe in a great danger that on the long run the revenues of the Islamic banks may be markedly smaller than those of capitalistic banks while their costs will be higher"(p.8). The author therefore believes that establishment of Islamic banks cannot lead to an evolutionary transformation of the economic order to an interest-free basis. He also feels that for improving their profitability and maintaining their viability. Islamic banks have to go in for some "innovative strategies", and in this connection suggests collaboration with small and medium- sized enterprises in Western countries which face shortage of risk capital in their home countries. In the same context, the author pleads that: "Governments therefore, should not restrain Islamic banks when employing profitably funds abroad but, on the contrary, should support such international capital movements resulting in a closer economic co-operation among Islamic countries but may be also between Islamic and Western countries".(p. 15).

The author has employed a simple arithmetical model to derive the conclusion that the profitability of Islamic banks would be less than that of interest banks. The basic flaw of this model is that it assumes complete certainty and predictability of profits. whereas in real life profits of an enterprise in any future time period cannot be predicted with certainty. The author states:

An entrepreneur who considers for a specific investment project the alternative offers of an Islamic and an interest bank will decide in favour of the PLS financing if the value of that part of the profit remaining to him after paying the Islamic bank the agreed-upon percentage of the project's profit is larger than the total expected profit of the alternative interest-based calculation and financing.

The author, therefore, postulates that "bargaining" will take place between the Islamic banks and the prospective entrepreneur, and this bargaining will result in the establishment of such a ratio of banks profit-sharing (brp) that the returns the Islamic bank will get on the funds provided by it will be no more than the ruling rate of interest in the case of interest banks. Since this is not enough to prove the author's thesis that the profitability of Islamic banks will be *less* than that of interest banks, he goes one step further and claims that entrepreneurs will present "too optimistic" projections of profits to Islamic banks. And, when actual profits fall below these projections, the return an Islamic bank will get on funds supplied, will be less than the ruling rate of interest because the rate of bank's profit-sharing (brp) would have been determined on the basis of the "too optimistic" projections.

Both the above assumptions made by the author in developing his model appear to be unwarranted. The first assumption that an entrepreneur will turn to an Islamic bank only "if the value of that part of the profit remaining to him after paying the Islamic bank the agreed upon percentage of the project's profit is larger than the total expected profit of the alternative interest-based calculation and financing" ignores the important fact that, apart from the religious aspect, the main attraction for entrepreneurs in dealing with Islamic banks lies in the Islamic bank being prepared to share in losses also. It stands to reason that on account of this unique feature of Islamic banking, entrepreneurs will not behave in the way postulated by the model. It is admitted even in Western economic theory that risk-bearing deserves and commands a reward. Since, unlike the interest banks, the Islamic banks will be participating in the risk of loss, it is most likely that the rate of return on money provided by Islamic banks would be higher than in the case of interest banks.

The second assumption made by the author that, the entrepreneurs would present "too optimistic" profit projections which would result in depressing the actual return to Islamic banks, is also questionable. In developing his line of argument, the author seems to ignore the fact that Islamic banks would not be bound to accept the profit projections submitted by the entrepreneurs. The Islamic banks would have their own technically qualified staff to assess the profitability of the projects for which the entrepreneurs seek bank's assistance. Of course, even with best technical expertise, profits in a future time period cannot be predicted with definiteness. But there is no reason to believe that Islamic banks would not be able to detect cases in which entrepreneurs might have presented "too optimistic" profit projections.

It is also important to observe that in developing his thesis, the author has proceeded on the assumption that Islamic banks would be working exclusively on PLS basis. This assumption vitiates the whole analysis and invalidates the conclusions drawn. It is well known that "*Shari'ah* permits the Islamic banks to employ other modes of business dealings such as *Bai-Muajjal*, leasing and hire-purchase. To the extent return on funds employed by the Islamic banks in these fields is higher than the prevailing interest rate the Islamic banks will be able to show higher profitability than the interest banks which eschew these fields.

The author has suggested that for improving their profitability and maintaining their viability, Islamic banks should go in for some innovative strategies like collaboration with enterprises in Western countries which face shortage of risk capital. Since this recommendation flows largely from the author's contention that Islamic banks will have low profitability, which thesis itself is not well founded, it follows that dealing with enterprises in Western countries is not a requirement for the survival of Islamic banks. however, investment proposals from enterprises in Western countries can be considered on the merits of each case by the Islamic banks.

Finally, it may be mentioned that the author has employed a purely materialistic approach in judging the success prospects of Islamic banks.

It is true that Western materialism has made serious inroads in the Muslim societies, however, large sections of Muslim population do want to re-order their lives in line with the injunctions of Islam. The resurgence of Islamic spirit is the greatest assurance for the success of Islamic banks and their onward march.