

Strategies to Settle Existing Debts under an Islamised Banking System

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In the wake of the Islamisation of the financial system of a country, an essential concern would be to transfer existing interest-bearing debt into mutually agreeable interest-free contracts. Such conversion is possible under an Islamised banking system because every increase, other than interest, over and above the basic debt is not forbidden. This study proposes a set of strategies that can be used as a guide to renegotiate existing interest-bearing contracts into equivalent interest-free contracts.

The Federal Shariah Court in Pakistan ordered the Government of Pakistan to change all such laws that contain provision for interest by 30 June 1992. The government has appealed against the decision in the Supreme Court of Pakistan. Interestingly, the court's decision also notes that:

"There have been made prayers invariably in the petitions that the interest be wiped off, or the interest paid already be counted towards payment of capital or that directions be issued to the banks and other financial institutions restraining them from claiming or recovering from the petitioners the amount of interest due against them on the loans borrowed by them. In this connection, we would like to make it clear that this court has a limited jurisdiction as to declaring a law or provision of law whether or not it is repugnant to the injunctions of Islam. It has no jurisdiction to grant any relief by way of issuing injunctions or staying proceedings pending before a Court of Law. All such prayers are thus misconceived and stand rejected " [PLD (1992), p. 180].

Obviously the judgement does not resolve the problems raised by the petitioners in the Shariah Court. However, it does raise an interesting question. If the Supreme Court upholds the decision of the Federal Shariah Court and the financial laws in Pakistan containing provision of interest are amended then what would be the status of the existing debt? The people in Pakistan, particularly the creditors and the debtors, are obviously puzzled as they do not know the fate of their deals. As these are likely to be settled in the framework of the Shariah laws, it is essential to explore possible ways of settling debt under an Islamised banking system. This study seeks to make a contribution in that direction. However it would certainly be beneficial if some related matters are clarified before proposing interest free measures to settle the existing debt. In this context, issues pertaining to the nature of money, public debt, and inflation with their bearing on *riba* (interest) are

discussed in Section I. Justification for paying debt service is discussed in Section II and proposals to settle debt are presented in Section III.

I. MONEY, DEBT, INFLATION AND THEIR BEARING ON *RIBA*

Status of Money in an Islamic System

True, interest is *riba* if the debt is made in terms of commodity money. This is evident in the tradition of the Prophet (PBUH) that exchange of equal for equal is for commodities like gold, silver, wheat, barley, dates, salt and so on [Sahih Muslim, 312]. It may be noted that the items mentioned include those commodities that were used as money during those days. Later on, paper money replaced commodity money as bills were issued up to the value of the commodities, particularly gold, kept in reserve. As the paper money represented the commodities behind it, the fall or rise in the value of those bills represented a fall or rise in the value of the reserve commodities.

The fluctuation in the value of the money itself results from changes in the real determinants of demand and supply of the commodity. The value of the money rises against some commodities and falls against others but, on an average, it commands a stable purchasing power. Therefore, the fluctuations in the value of commodity money represented relative price changes, and did not lead to inflation or deflation.

Paper money in vogue today is simply fiat money. Fiat money is an innovation whereby governments extract resources from the people. Issuance of fiat money itself is contrary to the principles of Islamic justice as it entitles the issuing authority to "steal" commodities belonging to the people. The Qur'an has clearly prohibited such transactions declaring them unjust [al-Baqarah: 188]. Besides, the Qur'anic principle of mutual consent [al-Nisaa: 29] in transactions is also violated as the people are coerced to relinquish part of their properties against fiat money which has no intrinsic value. Therefore, fiat money cannot be considered at par with commodity money or paper money fully backed by commodities in discussing the question of *riba*.

So, even though contracts stipulating excess payment on debt denominated in units of the same genre of commodities is *riba*, excess on debt contracted in the units of fiat money would not be *riba* because fiat money, contrary to commodity money, lends itself to deliberate manipulation in its purchasing power. Whenever the purchasing power is manipulated by the monetary authorities, the affected parties deserve compensation to the extent of financial damage inflicted on them. In a nutshell, fiat money is completely different in its character than commodity money and, therefore, it should not be treated at par with commodity money in addressing the question of *riba*.

Deficits and Debts

A government, a country, or an individual business or household that has a deficit has growing debt. Growing debt means paying more interest to service the debt, which, other things being equal, adds further to the deficit. So the ongoing deficits that remain unchecked create even larger deficits. Currently all debt, whether public or private, is denominated in units of fiat money. If you borrow to buy a car, you agree to pay back so many dollars over the next few years. But the value of those dollars depends on what happens to the price level till the loan matures. When the price level increases, the real value of an outstanding debt decreases consequently the borrowers gain and lenders lose.

The government is no exception. Fluctuations in the government sector budget arise, in part, from the government's reaction to economic fluctuations. In an economic boom, tax revenues increase and transfer payments decrease. Thus the government budget deficit decreases. The opposite occurs in a recession. When the real GNP sags as the economy goes into recession, tax receipts decline. Also the government spends more. A combination of a decrease in taxes and an increase in transfer payments increases the government budget deficit. Over and above these considerations, the government may try to stimulate the economy in a recession and to dampen down demand in a boom.

When the government has a deficit, it finances that deficit by selling treasury bills and treasury bonds. These bills and bonds are promises, denominated in the units of fiat money, to pay at some future date. But when the government borrows for many years, the real amount it repays at maturity of the loan depends on the amount by which prices have increased over the loan period. For instance, some of the debts incurred by the U.S. federal government in the late 1960s and early 1970s are being repaid in the early 1990s. Over the 20-year period, the dollar has fallen in value by the early 1990s so that more than three dollars are needed to buy the goods and services that one dollar could buy in the late 1960s. As a consequence, when the government repays in the early 1990s debts incurred in the 1960s, it is using dollars that are worth only thirty cents relative to the dollars borrowed by the government [Parkin and Bade (1992), p. 375].

Debt and Inflation

Islamic scholars get inspiration from the events in the early era of Islam to seek answers to contemporary problems. Inflation, and particularly its socio-economic consequences, is a phenomenon that was rare in those days. Inflation is a phenomenon of continuous and sustained increases, not ups and downs, in the average level of prices for several years which generally results from the manipulative actions of governments. The point is that a simple increase or decrease in the average price level is usually misconceived as inflation in discussing the issue of *riba*. Any charges over and above the principal amount lent would be *riba* provided that the price level remains stable. But inflation indiscriminately

generates injustice, the fundamental purpose of prohibiting *riba*, by favouring debtors at the cost of their creditors. In fact, injustice prevailing in contracts based on fiat money units is well recognised. That is why almost all fixed income contracts of salaries, pensions and so on, are periodically revised in order to compensate, if only in part, the victims of inflation. Unfortunately, lenders are left out in the cold without equivalent treatment and compensation for the losses inflicted by inflation. Such injustice must be wiped off by adopting policies to curb inflation and transforming existing contracts into just contracts. For instance, I have demonstrated elsewhere that *mudharaba* financing would not generate such injustice in an inflationary environment [Anwar (1987), pp. 67-70].

Growth in debt is partly checked by governments by increasing the growth in money supply which, in turn, increases inflation and yields an increased amount of inflation tax. This is, of course, unjust. Fluctuations in the inflation rate also make it difficult for people to predict the future value of money and makes it hard, therefore, for them to know how much to spend, save, borrow, and lend. So money, the measuring rod of value, becomes an unreliable measure. It is like using an elastic ruler to measure length. This is against the principle of justice as it violates the commandment regarding "complete measure" [Bani Israel: 35 and al-Muttafeen: 1-3].

What people pay implicitly because of a fall in the real value of money which results in a decline in the government debt is called inflation tax. This is the tax that is not legislated but, nonetheless, people end up paying it. The Inflation tax deprives people from their rightfully owned property to the extent of the devaluation of money. Of course, it is against the Islamic principle of justice. Unfortunately, the injustice is multiplied as it pervades the financial system and generates an imbalance in the debtor-creditor relations.

It is ironic that contemporary Muslim economists have failed to explain adequately the inflation phenomenon and its resultant injustice to the Shariah scholars. Consequently, the latter could not present the right solutions to inflationary problems. The scholars will, however, certainly get the right picture if they lend their own money for an extended period in an inflationary environment. Their experience will spotlight the difficulties of the victims of inflation and thus they will suggest the proper remedies.

II. JUSTIFICATION FOR DEBT SERVICE

Debt is incurred to purchase real assets for consumption and production purposes. On the one hand, inflation revalues the assets bought with debt money. On the other hand, inflation devalues the real money owed to the lenders as the contracts are signed in terms of fiat money. In this situation, returning the same number of IOUs to the lenders would be like returning debased coins after borrowing perfect coins which is, of course, unjust. Therefore the borrowers shall be

required to share the benefits, as well as hardships, resulting from the borrowed money, with their creditors.

In making loan contracts, the banks and the borrowers base their interest agreements on the opportunity cost (normal returns) of the funds, of course, remaining within the confines of the laws of the country. Similarly, if the parties had to deal on the basis of interest-free modes of financing, creditors would have certainly negotiated debt service charges to cover, at least, the opportunity cost of their funds. As the parties have followed the financial laws of the country when they entered into the debt contracts, and as the amendment in the laws would be *ex-post facto*, equity demands that the contracting parties shall be given opportunity to renegotiate their existing debts wherein the opportunity cost is accounted for properly.

Debt service in the form of interest payments made by the debtors to the creditors over and above the principal debt is *riba*. However, debt service (payment over and above the principal) in other forms would not be *riba*. It seems that *riba* in the sense of increase *per se* is not prohibited, even though the increase in the principal associated with the institutional debt arrangements during those days has been prohibited [al-Rum: 39]. For example, paying an extra amount on a borrowed sum is encouraged by the Prophet who has already set the precedent by paying more than the borrowed sum [PLD (1992), p. 70]. This incident reinforces the fact that the mere increase over and above the principal debt is not the Qur'anic *riba*. Similarly, *mudharaba* financing, the most favoured mode of financing, also entitles the grant of an increment to the principal amount despite there being no personal participation on the part of the financier in the relevant venture. In fact, the Federal Shariah Court in Pakistan has acknowledged in its current ruling on *riba* that "it can thus be concluded that interest [*riba*] is not an increase simpliciter but in the Shari'ah it is a special kind of increase...." [PLD (1992), p. 64]. Therefore debt service, extra payment made to financiers, is not *riba* if based on the interest-free mechanism.

III. SETTLING EXISTING DEBTS

In the light of the above discussion it is obvious that the debtors and the creditors must settle relevant portions of the debt service along with their basic debts. As the debt service in the form of interest is prohibited, it is of utmost importance to determine how to settle the existing interest-bearing debt while remaining within the confines of the Shariah. This section outlines an agenda of alternatives for consideration.

Banks have been actively providing financing on short, medium and long-term basis to their clients in order to contribute towards the development of agriculture, manufacturing, construction, wholesale and retail trade, transport, financing and business services, real estate, and other sectors of the economy. It is certainly desirable that a number of options be available to the parties for

renegotiating their contracts so that they can work out a suitable mechanism to settle their debts with mutual consent. The renegotiations shall primarily aim at preventing a collapse of the financial system in the country which opts for interest-free laws, while settling individual debts. In addition, to be successful, the settlement shall be based on the market considerations for the sake of greater flexibility in managing loan portfolios. The only rule provided by the authorities should be to reach an interest-free consensus within a stipulated period.

Issue of Interest Forgiveness

It would not be desirable to order banks to wipe off the interest due on the borrowers because the outstanding interest does not belong to the banks, it belongs to the depositors, who are known to be relatively poorer than the borrowers in Pakistan [Anwar (1992), pp. 1091-93]. It would certainly be unjust to benefit the wealthier at the expense of the poorer sections of the population on the pretence of prohibition of *riba*, the prohibition being basically meant to create justice in debt transactions [al-Baqarah: 279].

The banks have issued the existing debt from the deposits, probably interest-bearing, lying with the banks at that time. But as the existing debt matures, the funds so received are used to settle existing deposits. Currently all these deposits are interest-free in Pakistan. Interest forgiveness, if granted, will be counted as an expense by the banks and will damage those who made interest-free deposits in the banks hoping to get profit-share on their deposits. Interest forgiveness would mean rewarding those who have been dealing on the basis of interest at the expense of those who have followed Islamic principles. Would it be just to penalise the interest-free depositors by deducting interest loss from their deposits and, given the inflationary environment in Pakistan, retiring the deposits in devalued currency, while the earlier depositors have already taken interest due to them. The existing depositors would thus be forced to compensate for the losses against those debts in which they were never involved. Equity demands that the interests of the interest-free depositors should prevail over those who dealt in interest including the debt holders.

Besides, non-payment of interest to the banks may threaten closure of certain banks and could result in a chain reaction. Hence, in order to keep the financial structure intact, the contracts entered into before the enforcement of new laws be allowed renegotiations on the basis of suitable interest-free mechanics to recover debt service in lieu of accrued interest.

Amendments of laws allowing forgiveness of interest may lead to financial, economic, and political crisis in the country, a situation that would not be desirable from the Shariah point of view. It would be too dangerous an alternative for settling existing debt.

In addition, there will be a dilemma from the Shariah point of view. Interest-forgiveness would lead to violation of the Shariah principle regarding fulfilment of contracts. But if the contracts are honoured, the contracts themselves are against the

Shariah prohibition on interest, even though the laws of the land were observed. How could this dilemma be resolved? In such situations, The choice should be in favour of the lesser evil. Obviously interest forgiveness is not the lesser evil. Under the circumstances, therefore, there are two ways to settle the debt issue: either allow the existing contracts to liquidate according to the contractual agreements, or ask the contracting parties to renegotiate their contracts in the light of the Shariah principles. Preference must be given to an alternative that would warrant integrity of contracts, political stability, encouragement of banking activity, and socioeconomic development.

Generally, banks recover interest prior to the basic debt issued to their debt holders. Interest already paid by the existing debtors is a forgone matter [al-Baqarah: 178]. So the following proposals would be helpful for converting the outstanding interest into an Islamically acceptable debt service and the basic debt.

Debt Conversion Programme

The debt conversion programme may be categorised into (1) conversion of debt service; (2) conversion of existing debt into a new form of debt, called debt-debt swap; and (3) conversion of existing debt into an equity, called debt-equity swap, wherein debt service would be replaced by a dividend according to the terms and conditions of the equity ownership.

Fundamentally, a bank must determine how renegotiations affect the condition of the bank and the interests of its shareholders and depositors, now and in the future. This essentially involves a comparison between the amount a bank would expect to receive under the new package and what the bank expected on the original loan. This process involves complex judgements about the ultimate value of the existing loans and the merits of the various proposals.

Usually banks do not know how to price the risk associated with the projects wherein the debt money is applied. Lack of banks' expertise in evaluating the worth of the borrowers' businesses, projects, and assets demands a multifaceted approach.

The negotiating parties should be given the freedom in matters of how and in what form they agree to settle their debts, with the stipulation that the new contracts must be interest-free. Both parties must adjust to new realities. The common interest of the debtors and the creditors in maintaining a normal creditor-debtor relationship may lead to finding a middle way in fulfilling their mutual needs.

Debt Service Conversion

One possibility is to identify major variables responsible for inflation and compute compensation for the lenders from the borrowers on the basis of those variables. For example, it is well known that growth in money supply and inflation move together. Both inflation and money supply growth have a bearing on debt service. It is possible to negotiate debt service on the basis of the growth rate of money supply or the rate of inflation during the contract period:

The debt service may be based on the inflation rate in the sectors in which the funds are employed;
 debt service may be negotiated on the basis of the normal rate of profit in the sectors in which the debt money was employed;
 debt service may be based on the actual output, sales revenues or profits (accrued or imputed) to the borrowers during the contract period;
 debt service on public debts may be based on the social rate of return of the project financed by the debts; and
 debt service for those debts which cannot be identified with specific projects may be based on the growth rate of real GNP.

Debt-debt Swaps

Public debt may be converted into interest-free government bonds containing suitable tax incentives in lieu of debt service:

The debt denominated in local currency may be converted into another suitable currency on the basis of an exchange rate agreeable to both parties to the contract; and

The debts may be denominated in units of a real commodity on the basis of prices agreeable to both parties to the contract.

Debt-equity Swaps

Suppose that a firm obtained a loan worth 80 percent of the net worth of the total capital of the venture while 20 percent was the firm's own capital for a new project or a running project. The current value of the plant after Islamisation may be assessed by independent evaluators and the difference between the current value and the original value of the plant may be distributed as profits, in lieu of interest, among the parties in the ratio of their capital contribution or some other agreed upon ratios.

Another possibility is to sign fresh contracts on the existing loans on the basis of Islamic modes of financing such as *mudharaba*, *musharikah*, leasing and so on, for the remaining period of the loan contract. But the profit-sharing ratios or the rates of return agreed upon may be in favour of the financiers to such an extent that the debt service for the lapsed period may be integrated into the new contract.

Partial ownership of the firm's physical assets may be acquired in lieu of outstanding debts.

The banks and the borrowers may agree on the proportion for ownership of the company's quoted and unquoted shares against the outstanding debts.

Privatisation of public projects can also be used to settle the public debt. Exchange public debt against sale of government assets through a Privatising Trust created to sell the nonperforming assets. Government assets may be allocated price tags for the purpose of debt-equity swaps. All creditors should be eligible to raise a

bid in favour of the swaps. Creditors may buy the public assets against their debt. If they do not buy the assets then the government and the creditors shall agree on transfer of public debt to the private buyers of the public assets. This mechanism will clear the public debt and also facilitate the privatisation process.

Replace interest-bearing bonds with government investment certificates, taking into account the debt service for the lapsed period.

In performing debt-equity swaps, the proportion of shares to be owned by individual banks or a syndicate may be worked out when the firm is indebted to multiple creditors.

Real estate loans may be negotiated in terms of *Sharikah Mutnaqi'sa* (decreasing participation) in such a way that the debt service becomes part of the actual or imputed rent on the property. Neither of the foregoing can individually replace the interest mechanism. However, their case-by-case application, tailored with flexibility to meet each contract's unique needs, conditions, and prospects, will collectively lead to a smooth transition to the interest-free financial system.

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Comments on "Strategies to Settle Existing Debts under an Islamised Banking System"

The Federal Shariat Court in Pakistan, in its judgement of 1991 that declared interest in all its forms as *riba*, has not given any clear directives to the banks and other financial institutions regarding any claim or recovery of interest on the loans already advanced by them. Therefore, some important questions arise: first, what would be the legal position of the existing interest-bearing debts if the Supreme Court of Pakistan upholds the Judgement of the Federal Shariat Court? And secondly, could these debts be changed into mutually agreed interest-free contracts between the lenders and the borrowers?

In this well-argued paper the author addresses these hypothetical questions. He thinks that such a conversion is possible under an Islamised banking system. He starts his discussion with his assertion that every increase other than interest, over and above the basic debt, is not forbidden. If an increase over and above the basic debt is not *riba*, it may be asked, then what is *riba*; he does not elaborate this point. Actually, the paper suggests a set of strategies according to which existing interest-bearing debt could be changed into equivalent and mutually-agreed interest-free contracts.

The author rightly observes that, public debts, public finances and the purchasing power of money in modern times are in general related to the phenomenon of inflation. Such was not the case in the early period of Islam where there was no money economy in the modern sense and when *riba* generally pertained to commodity-money (and not fiat money). In modern times inflation has become a phenomenon of continuous and sustained increases in the average level of prices for several years. A simple increase or decrease in the average price level is wrongly taken by the Islamic, economists as inflation. Any change over and above the principal amount lent would be *riba* provided that the price level remains stable. Inflation becomes a palpable source of injustice when the purpose of prohibiting *riba* is to favour borrowers at the cost of their creditors. What the people pay as inflation tax deprives them of their property and this is against the principle of justice since it creates an imbalance in debtor-creditor relations. Fixed income groups and lenders suffer most in periods of rising prices and inflation.

In these settlements, according to the author, three processes are involved; namely, (1) conversion of debt service; (2) conversion of existing debt into a new form of debt; and (3) conversion of existing debt into an equity.

The author argues that in these renegotiations for new settlements of debts, the following important points must be taken into consideration: the parties must have full freedom to renegotiate; the inflation rate and the growth rate of the money

supply be correctly ascertained; debt service be negotiated on the basis of normal rate of profit, actual output or revenues, social rate of return etc. A public debt may be converted into interest-free government bonds, or into a suitable foreign currency.

I have three comments in this regard:

First, a modern economy is an organic whole which links and relates all sectors and areas in industry, agriculture, finance, trade and development together. This economy is also linked through a number of ways to the international economy through imports, exports, foreign exchange, balance of payments, international finance and trade relations and foreign loans. The paper does not say anything about the possible effects of Islamised banking on foreign lenders of loans on interest and on the Pakistani borrowers. Would it be possible to renegotiate with the foreign lenders our huge debt for debt-equity swaps? What would be its effects on our economy as a whole? What would be the nature of such resettlement of claims between, for example, the World Bank, the IMF and Pakistan?

Second, economic reality is not so simple as the paper visualises; it is complex and intricate. The problem of resettlement of claims in an Islamised banking within Pakistan is strictly a legal and moral problem. In the present state of our morality, prevalent corruption and bribery, any arbitrary method in determining the incidence of losses on the really aggrieved people will deprive them of their life savings because they do not wield any political influence. The recent defrauding of thousands of poor Pakistanis by the Taj Company, the Cooperatives, and many so-called Islamic finance companies, are current examples. Moreover, to finally determine genuine losses and damages in the wake of litigation of claims and their recoveries will be a stupendous task. The precise determination of incidence of such losses is very difficult.

Third, the overall debt settlements in a hypothetical Islamised banking system, as discussed by the author, are tied to variable rates of inflation, of GNP growth, social rates of return, real rate of return of a certain project, growth rate of money etc. for which consensus cannot be easily reached because people may differ as to the actual rates. There are differences of opinion on these rates among independent and government economists. If the author could have suggested a uniform policy for devising ways and means for determining such settlements through legislation, it would have enhanced the utility of the paper.

The paper lacks proper documentation. More evidence is needed to substantiate many propositions and hypotheses of the paper.

The critical stance of the author is commendable since he, unlike other 'Islamic' economists, does not take many things for granted in a dogmatic way.

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