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Islamic banking in South Africa – form over substance?

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Abstract

Purpose – The purpose of this study is to understand the economic substance of Islamic banking transactions in South Africa and to analyse whether the economic substance is closely related to the legal form. Additionally, this study highlights the similarities and differences in the execution of Islamic banking transactions across different South African banks. The transactions analysed are deposit products of *qard* and *Mudarabah* and financing products of *Murabaha*, *Ijarah* and diminishing *Musharaka*.

Design/methodology/approach – The study was conducted through interviews with representatives from each of the four South African banks that offers Islamic banking products. Interviews were semi-structured and allowed interviewees to voice their perspectives, increasing the validity of the interviews.

Findings – The study found that specific *Shariah* requirements of Islamic banking transactions are considered and included in the legal structure of the contracts by all four banks offering Islamic banking products. However, the economic reality of these transactions was often significantly different from its legal form and was found to, economically, replicate conventional banking transactions. The study also found that all four banks offer Islamic banking products under the same *Shariah* principles, but in some instances (e.g. diminishing *Musharaka*), execute these transactions in different ways. This study is the first of its kind in South Africa.

Research limitations/implications – While safeguards have been used to ensure the reliability and validity of the research, there remain a few inherent limitations which should be noted: interviewees, while chosen for their expertise and level of knowledge, may provide highly technical insight which may be difficult to interpret. Detailed technicalities were therefore excluded from this research. The regulatory environment of banks in South Africa, for example, regulation imposed by the Financial Service Board on all financial institutions in South Africa, has not been explored. However, the regulatory environment was brought to the readers' attention to help illustrate certain themes. This research uses only *Shariah* requirements as detailed in Section 2.2 to analyse transactions. Fatwas (rulings) issued by the *Shariah* Boards of South African Islamic banks have not been included in this study and may be an area of future research.

Originality/value – This study is the first of its kind in South Africa. The study adds to the Islamic banking literature by analysing the real execution of Islamic banking transactions rather than the theoretical compliance with *Shariah* law.

Keywords *Murabaha*, Islamic banking, *Ijarah*, Diminishing *Musharaka*, *Mudarabah*, *Qard*

Paper type Technical paper

1. Introduction

Islamic banking has seen phenomenal growth since its earliest experiments in Egypt in 1963 (Ariff, 1988). Islamic banking held US$1.8tn in assets globally at the end of 2013 and Islamic banking products were offered in more than 70 countries (Nazim and Bellens, 2013). The minority Muslim population of South Africa introduced Islamic banking through Al Baraka Bank which opened its doors in 1989 with HBZ Bank following in 1995. Islamic banking gained prominence in South Africa when two of the Big Four conventional banks, First National Bank (FNB) and ABSA, introduced Islamic banking windows in 2004 and 2006, respectively (Nazim and Bellens, 2013).

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Islamic banking is a manifestation of contemporary models of Islamic economics (Al-Arabi, 1966; Khan, 1986) and the concept of an alternate financial order, both of which include a moral and societal aspect missing from Western or secular economics (Ariff, 1988). Islamic banking is distinguished by its interest-free philosophy. The *Quraan* (the Holy Book of Islam) explicitly prohibits charging or taking of *riba* (interest), regardless of the reason for the loan or investment. Prohibitions in Islam are for the purpose of promoting societal welfare; yet, each prohibition allows viable alternatives, for example, wine and pork are prohibited for consumption in Islam, but many other foods and drinks are allowed. Similarly, Islam allows profit-and-loss-sharing (PLS) arrangements as the alternative to interest-based transactions. PLS illustrates capital as a factor of production, whereas profits earned merely because of the passage of time (interest) are not allowed.

Conceptual criticisms of contemporary Islamic banking have been noted since inception. Studies by Usmani and Taqi (1999), Kahf (1999), Karim (2001), Zaher and Kabir Hassan (2001), Laldin and Furqani (2012), Chong and Liu (2009) and Kahn (2010), to name a few, criticised the application of PLS principles and the inclusion of non-PLS transactions into the Islamic banking business model. Islamic banks formally state, using the relevant *Shariah* terminology, the types of PLS and non-PLS transactions offered and the terms and conditions of each type of transaction. *Shariah* texts are widely interpreted and applied with little regulation for consistency (Kamla, 2009). *Shariah* Supervisory Boards, the in-house *Shariah* counsel of all Islamic banking institutions, lend legitimacy to transactions by a process of formal approval when in compliance with *Shariah* (Mansoor Khan and Ishaq Bhatti, 2008). Common members on the *Shariah* Supervisory Boards of different Islamic banking institutions ensure consistency to some degree (Bassens *et al.*, 2010); however, there is no literature to support or dispute this. While the above studies have widely debated the risk-sharing element of PLS transactions and the permissibility of use of non-PLS transactions, no specific research has been done on the practical execution (transactional analysis of Islamic banking transactions) at an individual bank level, and whether these transactions meet the requirements of *Shariah*.

Islamic banking in South Africa is still in its infancy in terms of both market penetration and length of operations. Only two of the Big Four South African conventional banks (ABSA and FNB) offer Islamic banking products, and the two other market participants are small subsidiaries of international banks. Islamic banks in South Africa only offer *qard* and PLS-based *Mudarabah* transactions for deposits and offer the PLS-based diminishing *Musharaka*, as well as the non-PLS-based options of *Ijarah* and *Murabaha*, for financing. Modes of Islamic deposits and financing are explained in Section 2.2.

To date, only two studies have been performed on the South African Islamic banking market, those of Abdullah (2010) and Vahed and Vawda (2008). Both studies focused on the consumer who transacts with Islamic banks, and not on the Islamic banking products. The purpose of this study is to understand the economic substance of Islamic banking transactions in South Africa (i.e. how these transactions are executed in practice and the ultimate cost or benefit to the bank and customer) and to analyse whether the economic substance is closely related to the legal form. Additionally, this study highlights the similarities and differences in the execution of Islamic banking transactions across different South African banks. This study is the first of its kind in South Africa.

2. Theoretical and analytical framework

2.1 Theological constructs of Islamic banking

The central belief of Islam is that the universe and all that is in it is controlled by one true God, the Almighty Allah. He created man and put man on earth to fulfil certain objectives by

obeying His commands. The commands of Allah (SWT) do not focus solely on religious rituals but cover every aspect of life. These commands are not so narrow as to leave no room for human intellect nor are they so broad as to be ambiguous and open to perception or desire. As such, Islam has provided human beings with a set of principles to govern their activities. The vast capabilities of human intellect are limited by subjectivity and human emotion which then limit humans' ability to reach truth. The principles provided by Allah (SWT) through His Messenger Muhammed (Peace Be Upon Him) counter that limitation, and, if obeyed, create a just and fair society (Usmani and Taqi, 1999).

2.2 Shariah *requirements of Islamic banking transactions*

The *Shariah* law requirements of each of the Islamic banking transactions analysed as part of this research have been detailed below. An understanding of these requirements is necessary to understand the legal structure and the economic substance of Islamic banking products offered in South Africa.

2.2.1 Qard *transactions.* In Arabic, *qard* literally means "to cut". This is in reference to the lender "cutting off" the asset from him and giving it to the borrower. *Qard* is a loan which a person gives to another as a help, charity or advance for a certain time. One of the key features of *qard* is that its payable on demand. Another distinguishing characteristic of *qard* compared to other forms of Islamic loans is that the same quantity of a similar commodity can be returned to the lender. This allows consumable and non-consumable assets to be loaned on a *qard* basis (Usmani and Taqi, 1999).

2.2.2 Mudarabah *transactions. Mudarabah*, the chosen mode of allocating returns to depositors for Islamic banks in South Africa, is a partnership between two parties, where one partner provides capital and the other contributes expertise and management of the business. During the period of this partnership, the capital provider has no involvement in a business' day-to-day operations. Profits are shared on a pre-arranged basis, but losses are borne solely by the capital provider (it is presumed that hard work and effort without compensation is the loss of the other partner). Another distinguishing feature of *Mudarabah* is that any assets purchased by the partnership remain the property of the capital provider and any unrealised capital appreciation cannot be shared with the other partner. If the assets are sold and a profit is made, those profits may be shared on a pre-arranged basis (Usmani and Taqi, 1999).

2.2.3 Murabaha *transactions.* Like *Ijarah*, *Murabaha* transactions are for general commerce and not financing. In its true Islamic connotation, *Murabaha* is a specific type of sales transaction, whereby the seller discloses the cost of his commodity and the mark-up to the buyer. As such, the rules relating to sales transactions apply. According to Islamic jurisprudence, for a sale to be valid, the sale commodity must physically exist at the time of the sale, owned by the seller, and the seller must have physical or constructive possession of the commodity. Furthermore, the sale must be instant and absolute (i.e. sale at a future date is not allowed), and the delivery of the commodity should be certain and the price must be certain. Islamic sales transactions are unconditional (Usmani and Taqi, 1999).

A sale that is concluded on a deferred payment basis is referred to as *bai' muajjal.* In this type of transaction, the date of the payment in the future should be fixed in an unambiguous manner, and the deferred price may be different from the cash price. Islamic banks use a combination of the *Murabaha* and *bai' muajjal principles* to finance assets. Often, the customer purchases the asset from the supplier on behalf of the bank (as an agent) and then offers to purchase the asset from the bank (at a mark-up). Similar to *Ijarah*, the agent agreement is separate from the sale agreement and any conditions attached to the agency agreement or the sale agreement will render both agreements void. If the bank does not

assume ownership risk (preferably physical possession) between the date of delivery from the supplier and the date of conclusion of the *Murabaha* transaction, the conditions for sale will not be met (Usmani and Taqi, 1999).

2.2.4 Ijarah *transactions. Ijarah* is a term that relates to the usufruct of assets and lexically means "to give something on rent". It is analogous to leasing. *Ijarah* is not a mode of financing in origin, but rather a normal commercial activity, like a sale. (Usmani and Taqi, 1999).

A number of conditions should be met for a transaction to qualify as an *Ijarah* transaction. Firstly, there should be an identifiable asset, a clearly identifiable owner and a lessee, whereby the owner transfers the usufruct of the asset to the lessee for an agreed period, at an agreed consideration. The consideration should be absolutely determined at inception for the duration of the contract. Ownership remains with the owner and only the right to use the asset is transferred to the lessee. Anything which is consumed by use therefore cannot be leased. Costs relating to ownership should be borne by the owner, while costs relating to use should be borne by the lessee. The lessee should compensate the owner for any costs due to negligence; however, the owner retains full risk and is liable for all losses beyond the control of the lessee. The lease period commences on the date the lessee takes possession of the asset. The lease terminates at the agreed date or if the leased asset has totally lost the function for which it was leased. Ownership of the lease remains with the owner after the lease has been terminated. If the parties wish to renew the lease, or if the owner wishes to sell or give the asset to the lessee, it will form part of a new transaction (Usmani and Taqi, 1999).

When *Ijarah* is the mode of financing and the lessee procures the asset to be leased, it should be understood that the procurement of the asset is independent of the *Ijarah* transaction. The procurement is a principal–agent transaction, where the lessee acts as the bank's agent. Cost associated with transfer (e.g. customs and transport) should be borne by the principal. *Ijarah* conditions are not applicable during procurement, and lease payments are not due until the asset has been delivered and the *Ijarah* contract agreed (Usmani and Taqi, 1999).

2.2.5 Diminishing Musharaka *transactions. Musharaka* is a form of partnership, which literally means "sharing". In a business context, it means a joint arrangement, whereby all partners share in the profits and losses of the joint arrangement. Profits may be shared on an agreed-upon ratio, but losses must be shared in direct proportion to each partner's holding in the joint arrangement. The normal principle of *Musharaka* is that each partner has a right to take part in the management of the joint arrangement; however, the partners may agree on a condition that the management will be carried out by one of them. In that case, the silent partner cannot be entitled to a profit ratio greater than the value of his investment in the joint arrangement. *Musharaka* agreements may be terminated through the purchase of shares of one partner from another (Usmani and Taqi, 1999).

Diminishing *Musharaka* is a form of *Musharaka* developed recently, whereby two (or more) partners enter into a joint arrangement over an asset, with the one party having exclusive use of the asset. The partner using the asset then pays rental to the other partner (or partners) for the use of their share of the asset. A key feature of diminishing *Musharaka* is that the partner using the asset undertakes to systematically repurchase the shares from the other partner (or partners) over a period of time. A diminishing *Musharaka* agreement should be effected over four stages. Firstly, joint ownership of the asset comes about when both partners (assuming only two partners to the agreement) contribute to the acquisition of the asset. Secondly, the one partner leases his share of the asset to the other partner who occupies or uses the whole asset. Thirdly, the partner occupying or using the asset undertakes to systematically purchase the other partners' share in the asset in equal

instalments over time. The third stage cannot be a condition of the original *Musharaka* (Stage one), as it will cause the *Musharaka* contract to be void, rather it should be structured as a separate promise. The original *Musharaka* agreement and the systematic repurchase of the other partners' share by the occupying partner may not be contained in the same agreement. The original *Musharaka* agreement and the agreement to lease may be contained in the same agreement. Fourthly, at each date of repurchase, the repurchase price should be offered and accepted at that date. It is preferable that the repurchase price be based on the market value of the asset at the repurchase date; however, purchase prices may be pre-agreed (Usmani and Taqi, 1999).

3. Literature review

Islamic principles involving commerce promote free business enterprise with a profit motive and recognise market forces but restrict certain economic activities. Dealing in interest, hoarding, dealing in unlawful goods and services, gambling and speculative transactions are some examples of restricted activities. These restrictions are aimed at combatting human weaknesses such as greed while maintaining balance and distributive justice and creating equal opportunities in the economy (Usmani and Taqi, 1999).

The basis of Islamic commercial transactions, derived from Islamic jurisprudence, inherently embodies Islamic principles of balance, fairness and distributive justice. An Islamic banking system, by definition, should be differentiated by being interest-free, multi-purposed (not merely commercial) and equity-oriented (Ariff, 1988). This shows the concept of Islam as a way of life, permeating all areas of life, rather than being merely a religious pursuit.

There is overwhelming literature (Siddiqi, 2006; Kamla, 2009; Beck *et al.*, 2013; Salleh, 2012) on how the differentiating factors listed above do not form part of the core business model of Islamic banks. The literature suggests that Islamic banking is not, in substance, interest-free. Chong and Liu (2009) conducted a study on the correlation of Islamic banking to conventional banking returns and concluded that overall Islamic deposits are not much different from conventional deposits. Changes in interest rates prompted changes in Islamic deposits' investment rates, while the reverse was not true.

All contemporary papers on Islamic economics and, by inference, Islamic banking (Al-Arabi, 1966; Uzair, 1978; Siddiqi, 1983; Khan, 1986) emphasise the role of ethical, moral and social considerations in Islamic finance. Islamic banks administer and use public funds and should serve in public interest. Ariff (1988) asserts that Islamic banks should play a social welfare role, instead of a profit maximisation role. This leads one to question whether Islamic banks embed non-commercial factors in their business models. Rethel (2011) analysed whether ethical and moral dimensions were included in Islamic banking, and found that Islamic banking is more concerned about presenting itself as a normal financial activity and largely reproduces conventional banking.

PLS promotes the spreading of risk between the bank and investor. Beck *et al.* (2013) found that Islamic banks were better capitalised and had higher asset quality. Islamic bank share prices also performed better during times of sub-prime crisis for the same reasons (Kamla, 2009). However, non-PLS transactions now make up more than 90 per cent of Islamic banking transactions (Khan, 2010), the economics of which closely resemble interest.

Conceptual criticisms of the application of Islamic banking have been noted since the inception of contemporary Islamic banking. Studies in Bangladesh (Huq, 1996), Egypt (Siddiqi, 1983) and Pakistan (Khan, 1986) have criticised the application of the PLS principles and the inclusion of non-profit-sharing transactions in the Islamic banking business model. Recent studies conducted in countries with more mature and material Islamic banking

industries (Saudi Arabia, United Arab Emirates, Qatar, Kuwait and Bahrain) have revealed a disconnect between the true spirit of *Shariah* law and Islamic banking (Iqbal and Molyneux, 2005). Ahmad (1994) theorises that the apparent similarities between conventional and Islamic banking were simply a transitional phase implemented to steer away from conventional banking, as Muslim clients had to be offered products that they recognised. However, after over four decades of Islamic banking, there is no evidence of a drastic move away from conventional banking. Chong and Liu (2009) noted that competitiveness was a key factor in Islamic banking mimicking conventional banking, as most countries operate a dual banking system and Islamic banks face the risk of "withdrawal" should the *Shariah* law be strictly applied which would result in losses for depositors. Haniffa and Hudaib (2010) discussed the evolution of Islamic finance and explored the tensions and conflicts in the political and socio-economic environment to illustrate how "intentions" change.

Islamic banking was introduced as an interest-free alternative to interest-based banking practised globally and has gained momentum since its inception in 1963. The core concept of Islamic banking is to participate in the profits from money invested, rather than merely to obtain a return based on time. Research in Saudi Arabia, the United Arab Emirates, Egypt and Malaysia has highlighted a trend moving away from profit-sharing transactions towards trade-type transactions with financing elements. There has been a similar trend in South Africa, although no research has specifically focused on Islamic banking transactions in South Africa.

4. Research methodology

4.1 Research paradigm

Research in the accounting sphere has largely been conducted using positivist research, with objective empirical evidence supporting conclusions and generalisations (Maroun, 2012). As Maroun (2012) points out, accounting is far more complex than formal quantitative research allows and may benefit from "alternative" or interpretive/critical research. Critical research has its roots in Marxist philosophy and seeks to challenge "taken-for-granted" social, political and economic structures and exposes structures of power or domination, therefore assuming that there are marginalised groups whose best interests are not being served by existing structures (Cannella and Lincoln, 2004). While critical research is more subjective, it allows for social and societal aspects to be included which may not be covered in quasi-scientific positivist research. Subjectivity does not detract from validity and reliability of the research, rather it is achieved from full disclosure by the researcher on the perspective of the study, detailed documentation of findings and rigorous data collection and analysis (Creswell *et al.*, 2010; Maroun, 2012).

Because of minimal research conducted on Islamic banking in South Africa, a qualitative approach of detailed interviews was used, grounded in critical epistemology (Creswell *et al.*, 2010; O'Dwyer *et al.*, 2011; Maroun, 2012). This research adopted a strong advocacy approach with the aim of bringing change to Islamic banking in South Africa (refer to Section 1.1).

4.2 Method

Detailed interviews are the best method for obtaining facts and gaining insights into understanding the reasons behind certain actions (Rowley, 2012). Interviews are especially useful for researching new or less-explored areas (Creswell, 2013). Questionnaires were considered but discarded because of the varied and detailed nature of information sought, as this research is focused on the breadth and depth of information rather than quantum, which is better obtained through interviews. Interviews further have the potential to provide the

researcher with research angles not contemplated in this research (Rowley, 2012). Lastly, as key people in the Islamic banking industry in South Africa were targeted, it was more likely that these busy people would be willing to share their insights and opinions during interviews than taking the time out to fill out questionnaires (Rowley, 2012).

Prior research on Islamic banking largely used publicly available information (Kahf, 1999; Karim, 2001; Zaher and Kabir Hassan, 2001; Laldin and Furqani, 2012; Kamla, 2009; Rethel, 2011) or questionnaires (Wajdi Dusuki and Irwani Abdullah, 2007; Bassens *et al.*, 2010; Beck *et al.*, 2013) to conduct research, resulting in research that is one step removed from what is happening in practice. Interviews with senior management at Islamic banks in South Africa allow the researcher to walk through the execution of a transaction as would be done in day-to-day operations providing insight and information to perform the research analysis. Interviews were, therefore, selected as the basis for acquiring data for this research.

Shariah law, including its moral and societal aspects, and the basic understanding of Islamic banking transactions in South Africa as obtained from the relevant banks' websites were used to develop the interview agenda. The interview agenda was subject to peer review by supervisors, fellow researchers at the University of Witwatersrand and was piloted by two partners (familiar with Islamic banking) at Big Four audit firms, as recommended by Llewelyn (2003), O'Dwyer *et al.* (2011), Maroun (2012) and Rowley (2012).

Subjectivity and the researcher's involvement in the collection of data are some of the characteristics of interviews (Creswell, 2013). These characteristics are unique to qualitative research but do not detract from the validity or reliability of the method (Creswell *et al.*, 2010). Researcher bias could be a factor in one of the processes of setting up, holding, transcribing or analysing interviews (Creswell, 2013; Rowley, 2012) and threaten reliability. In this study, the researcher ensured that only experienced interviewees were chosen (Section 4.2.1), that the interview agenda was appropriately designed and tested and that a thorough analysis of the data was performed resulting in reasonable assurance on the reliability and validity of findings (Creswell, 2013; Rowley, 2012).

4.2.1 Sample. The sample of people interviewed was purposefully selected, taking into account the bias this brought to the research. The researcher was mindful of choosing interviewees who would provide the most useful and in-depth information. The process resulted in the selection of two senior people at each of the banks that offers Islamic banking products in South Africa as the sample. This was deemed appropriate and as these key people are in positions to provide the information sought to achieve the purpose of the study. As all banks that offer Islamic banking products in South Africa were included in the sample of interviews, saturation was achieved (Rowley, 2012). All interviews were semi-structured to ensure focus on the research question and to examine (thoroughly) the subject (Holland, 2005; Leedy and Ormrod, 2014; Rowley, 2012). As recommended by Rowley (2012), a total of 9 interviews was conducted, ranging from 40 to 90 min each.

4.2.2 Ethical considerations. Interviewees were granted personal anonymity to guarantee their full cooperation (O'Dwyer *et al.*, 2011). However, participants were advised and did not object to the Islamic bank or conventional bank offering Islamic banking products being specifically mentioned in the research report. Participants were interviewed in familiar settings so that they would be at ease (Rowley, 2012). Interviewees were granted the power to stop the interview at any time which was designed to contribute to their willingness to participate and be forthcoming (Creswell *et al.*, 2010). During the review of the interview agenda, peers, colleagues and people involved in the pilot study were requested to provide feedback on whether any of the questions poses an ethical dilemma for interviewees.

4.3 Data collection

Data collection and analysis used a case study approach with the researcher continuously analysing actual South African Islamic banking transactions with reference to its ideal *Shariah*-compliant counterpart. Certain interviewees were expected to have full knowledge of *Shariah*. As the purpose of the research was to understand the economic substance of Islamic banking transactions, participants were asked indirect questions without the researcher leading or directing the interviewee down a certain path.

The duration of interviews ranged from 40 to 90 min and allowed for the themes to be explored in sufficient detail (O'Dwyer *et al.*, 2011). Interviews were held between June and November 2015. Six of the nine interviews were held face-to-face at the offices of the respondents in Johannesburg and Durban. Three of the nine interviews were held over the telephone with respondents who were based in Durban. Telephone interviews minimise interviewer bias, but at the same time, minimise the rapport and the richness as experienced in face-to-face interviews (Rowley, 2012). Research by Aziz and Kenford (2004) and Rohde *et al.* (2014) found that telephone interviews were a reliable method of interviewing and that the economic and logistical advantages outweighed the marginal differences noted when compared to face-to-face interviews.

4.4 Data analysis

Data analysis commenced with a detailed review of prior literature on the *Shariah* relevance and compliance of current Islamic banking practices globally. The aim was not to summarise every argument for or against current Islamic banking, but rather to identify the major advantages and pitfalls of modern-day Islamic banking. The reviewed literature was organised using a content analysis.

Data obtained from transcripts were analysed several times through data reduction, data display and data verification (O'Dwyer *et al.*, 2011). Themes were naturally identified as the four different types of Islamic banking transactions offered in South Africa. Data were initially analysed on a holistic level by analysing the business model of each bank offering Islamic banking transactions. Next, the *Shariah* requirements of these transactions formed the categories by which interview data were organised (Rowley, 2012).

An informal coding scheme was developed to analyse the subtler themes in the interviews. Specific attention was paid to contradictions within interviews and amongst interviewees (Patton, 2015). Subsequent readings of the transcripts added to these themes, and this process was repeated until a sense of saturation of the issues was experienced by the researcher (Holland, 2005; Leedy and Ormrod, 2014; O'Dwyer *et al.*, 2011).

5. Findings

5.1 Overall findings

Each of the banks offering Islamic banking in South Africa offers both deposits and financing products. All of the banks included in the study offer the equivalent of a conventional cheque or current account on a *qard* basis on which no returns are paid to the customer. All of the banks also offer customers the option of several types of savings accounts on which returns are earned on a pre-agreed basis under the PLS-based *Mudarabah* (equity investment) principle. On the financing side, all of the banks offer property finance under PLS-based diminishing *Musharaka* (partnership), although this is executed differently at each of the banks. HBZ Bank also offers motor vehicles and asset finance under diminishing *Musharaka* (partnership). The non-PLS mode of financing, *Murabaha* (cost plus) is used by Al Baraka Bank to offer motor vehicle, asset and property finance with a maximum term of seven years. *Murabaha* (cost plus) transactions are used by the HBZ Bank only for trade finance (e.g. inventory) with a maximum term of 90 days. The other non-PLS

modes of financing, *Ijarah* (leasing), are used by ABSA and FNB Islamic banking windows for motor vehicle and asset finance. A summary of the transactions offered by each bank including the transaction modes (i.e. PLS or non-PLS) is tabulated in Table I.

Islamic banking has come under criticism globally for merely putting an Islamic veneer on conventional products (Khan, 2010) and that sentiment continues to exist even amongst those operating Islamic banks:

> So the way we operate, [and the other banks] are similar and I think that it's a problem across Islamic banks across the world in that at the moment we are just trying to replicate conventional products, we are almost playing catch-up. (R3)

> Islamic banking in South Africa is relatively new so people don't understand the concepts, the closer it [Islamic banking] is aligned to conventional banking, the more you get your market to take your product. (R6)

> The substance in essence is the same as conventional banking and is made *Shariah* compliant in terms of the contract. (R8)

5.2 Findings on qard *transactions*

In Islamic principles, *qard* is a loan given to another as help, charity or advance repayable on demand or at a specific time. In a South African Islamic banking context, Islamic banks borrow money from depositors as advances to run the Islamic business (R5). Respondents explained that operationally *qard* accounts are structured the same as conventional current or cheque accounts on which no returns are paid:

> […] [On] the *qard* account we cannot give any profit on that account, because the *qard* is there, we took the loan from the customers. If we took the loan from the customer and we pay anything on that *qard* [it] is equal to interest. (R7)

Islamic banks use *qard* funds to generate returns, yet do not pay any of these returns to depositors as that would be interest and in contravention of *Shariah*. However, transaction fees are still levied on *qard* accounts similar to conventional cheque and current accounts:

	Al Baraka Bank	ABSA	FNB	HBZ Bank
Qard	Deposits – no returns	Deposits – no returns	Deposits – no returns	Deposits – no returns
Mudarabah	Deposits – pre-agreed returns	Deposits – pre-agreed returns	Deposits – pre-agreed returns	Deposits – pre -agreed returns
Murabaha	Financing – trade financing (e.g. inventory), motor vehicles, equipment, property (max 7 years)	Not offered	Not offered	Financing – trade financing only (e.g. inventory)
Ijarah	Not offered	Financing – motor vehicle and asset finance	Financing – motor vehicle and asset finance	Not offered
Diminishing Musharaka	Financing – Property	Financing – commercial property only	Financing – Property	Financing – property, motor vehicles, equipment

Table I. Types of Islamic banking transactions available in South Africa per bank

> So one element is the element of bank charges and the services we provide, so we pride ourselves on the fact that we provide a service that is compatible and on par with what the conventional bank offers. (R5)

Islamic banks have encountered complications when running promotions on the cheque accounts, as any benefit derived by the depositor from having loaned the money to the bank may be construed as interest:

> […] so for example on their cheque accounts we are giving a competition where you could win tickets to something. So the *Shariah* questions were, can you [the depositor] derive benefit and will it then be interest? So you'll have those kinds of issues where we're constantly going back to the *Shariah* board to say we want to run this campaign or this promotion, can it work or can't it work and how do we change it. What the *Shariah* board said, based on the transaction, if you [can] get the customer to use his ATM three times a month or whatever, based on that you can give a prize, but you cannot give a prize for just having a cheque account. (R3)

5.3 Findings on Mudarabah *transactions*

Respondents confirmed that all deposit products on which returns are paid are offered under the *Shariah* concept of *Mudarabah* (partnership). Depositors' money is mobilised in a variety of ways to earn returns. Respondents from each of the Islamic banks interviewed declared a mismatch, in that the value of money received from depositors was significantly more than the money loaned to borrowers. Excess cash available from depositors is invested by the Islamic bank in equity or commodities or other short-term investments (R1, R3, R5, R7). The returns from these investments are pooled and shared with depositors on the pre-agreed profit ratio.

The profit share percentage differed across each of the banks ranging from a 40:60 ratio, with the bank taking 40 per cent and the depositors receiving 60 per cent of profits, to an 80:20 ratio, where the bank keeps 80 per cent of the profits and distributes to customers 20 per cent. The difference in profit ratios is attributed to the method of distributing profits which is done on a gross basis before deducting the bank's operating expenses or on a net basis after deduction of the bank's operating expenses (R7).

One of the key features of a *Mudarabah* profit-sharing arrangement is that the depositor must be exposed to the risk of losing capital for the transaction to be valid in terms of *Shariah*. Respondents acknowledged that the risk exists but emphasised that the probability of the depositor losing their deposits are slim:

> […] we don't want to put our customers fund at risk, because under *Mudarabah* it's a PLS agreement, we try to minimise the loss by structuring the trades so that when we buy [equity or commodities], we already know we can sell it in the market or we've got a buyer and we close out. (R3)

> In Islamic bank, there's a risk to the depositor and shareholder. The deposit is not guaranteed, like any other institution also. In Islamic banking you obviously have a higher risk. So in theory you can lose a deposit. In practice, obviously, banks will put controls in place to try and restrict the losses but Islamic banking […]' (R1).

5.4 Findings on Murabaha *transactions*

Only Al Barak Bank and HBZ Bank use *Murabaha* as a mode of financing. The Al Baraka Bank uses this mode of financing to finance short-term assets such as inventory and longer-term assets such as equipment, motor vehicles and property. The maximum period over which *Murabaha* financing is offered by Al Barak Bank is seven years. HBZ Bank uses

Murabaha to finance inventory only with a maximum term of 90 days. *Murabaha* is a non-PLS mode of financing and is better suited to ordinary trade transactions rather than financing. Islamic banks in South Africa, however, deem the *Murabaha* financing activities to be a form of trade:

> We don't do lending or financing. Islamic banking, there is no concept in Islam for lending or financing. We do *trading*. *Murabaha* is a *trading* transaction (R7, emphasis added).

Operationally, *Murabaha* transactions involve a complicated set of processes and agreements that are required to be fulfilled in a specific order for the transaction to be *Shariah*-compliant:

> […] [if the] client [customer/borrower] wants to buys goods, [the] goods are sourced [by the customer/depositor as the agent], and goods are [then] delivered to the customer. Before the client uses the goods, the supplier invoices the bank, and the bank pays the supplier. The customer cannot use those goods once he receives them [those goods], until the bank sells him those goods. The bank will then make the sale out to the customer. Say the goods cost R100 000 we sell it to you [the customer/borrower] for R120 000 the amount is due in three months' time. When the customer accepts the sale the customer can use those good and can dispose of it. This is a[n] [inventory] trade transaction. (R1)

A key feature of *Murabaha* transactions is that both the buyer and seller know the original cost price of the product and agree on the mark-up. Engaging in *Murabaha* trade would imply that the mark-up is based on the market price of the asset being resold. However, the mark-up is based on the rate of return the Islamic bank wishes to achieve for depositors:

> […] the transaction will be determined in terms of what the deposit rate is, [the desired deposit rate will determine] what the profit mark-up is. (R1)

Buying and selling of assets at a mark-up but allowing for repayment terms to extend over a long period blurs the boundaries between a financing and a trade transaction. The financing component creates regulatory complications in terms of the National Credit Act of 2005 (NCA) where Section 125 (c) prescribes that, in the case of early settlement, the credit provider may not charge more than a maximum of three-months' future interest forfeited as a termination fee. In the case of *Murabaha* transactions, it is not interest but rather the profit on the mark-up that is received over the course of the contract. In terms of *Shariah*, the profit remains the same regardless of the settlement date and may not be reduced or altered after it has been agreed upon by both parties. To retain *Shariah* compliance and comply with the NCA, some of the Islamic banks interviewed require full settlement of the agreed-upon price and thereafter gift an amount back to the customer. Alternatively, Islamic banks allow settlement of *Murabaha* transactions at a discount:

> In practice if someone [a customer] comes and said [that they wished to] settle early, we will give the person [customer] a discount, it's not a contractual obligation it's a prerogative of the bank. We give a discount if we wish. If you owe R125 000 after two years and you want to pay it off, we say ok you can pay R105 000, a discount on the marked-up price, at the prerogative of the bank (R1).

5.5 Findings on Ijarah *transactions*

ABSA and FNB Islamic banking windows use the *Shariah* principle of *Ijarah* or leasing for the vehicle and asset financing, with ABSA using both a fixed and variable rental structure. *Ijarah* is a non-PLS mode of financing. For *Ijarah* transactions to be *Shariah*-compliant, the contract must be executed as an operating lease.

ABSA and FNB Islamic banking windows follow the same processes as *Murabaha* in executing the transaction. To illustrate, if a customer wishes to purchase a motor vehicle, the

client comes to the bank and indicates that they need to buy a motor vehicle. The Islamic bank then appoints the customer as an agent. The customer now sources the car from a motor car dealer and once the car is chosen, the motor car dealer makes an invoice to the Islamic bank, which means that Islamic bank effectively takes ownership of the vehicle. Thereafter, the transaction price is determined, and the vehicle is leased to the individual at a mark-up:

> Once we approve your credit, you find the vehicle; the bank purchases the vehicle and leases it to you over a specified period of time. (R6)

> [And you add a profit element to the cost before you lease it?] The *Murabaha* is the underlying structure for most Islamic transactions; it's more the overlay in term of all the other obligations that come through with all these other structures [i.e. *Ijarah*]. (R5)

At the end of the lease terms, the car is transferred to the customer for no consideration or given as a gift to the customer.

> […] when he [the customer] makes his final payment in the lease, he'll get the final documentation where ownership is transferred. (R5)

The mark-up added to cost of the asset before it is leased is not based on the market price of the asset leased but rather determined using conventional banking benchmarks:

> So we base it [the mark-up on *Ijarah* transactions] on [the bank's] lending rate. Essentially from our perspective, from [the larger bank's] perspective, the pricing issue was that we want to standardise pricing, whether it is conventional or Islamic, you [the customer] are paying the same price. So the view from the *Shariah* scholars, whether we benchmark it through [the bank's] rate or the prime rate does not make that [the transaction] not *Shariah* compliant, because the benchmarking is not the issue, it's the actual interest that's the issue. (R3)

The only difference between the structure of the *Murabaha* and *Ijarah* transactions is that in the *Ijarah* transactions, the Islamic bank retains the title deeds of the asset even though ownership passes to the customer:

> The reason you do that [retain title deeds bust transfer ownership] in an operating lease type structure is that the customer is responsible for servicing the vehicle, if he [the customer] has an accident, he [the customer] can't tell the bank it's your [the bank's] car, you [the bank] fix it. (R5)

The structure of *Ijarah* transactions bypasses the complication of compliance with the NCA as explained under *Murabaha*. If the customer wishes to settle early, the rental for the period the car was used is charged and if the customer wishes to purchase the vehicle, a price is then negotiated:

> "[Would the customer pay less than the total value of lease payments?]": Yes, because then you [the customer] are basically purchasing out the rest of the period of the rental. So then we [the Islamic bank] would negotiate a price.

> When we [the Islamic bank] negotiate a price, we [the Islamic bank] can negotiate cheaper than the full period rental. And that's what happens in conventional [banking], they would give you a discount. (R3)

5.6 Findings on diminishing Musharaka *transactions*

Al Baraka Bank, ABSA, FNB and HBZ Bank each offers property financing under the *Shariah* principle of diminishing *Musharaka*. ABSA uses this mode of financing for commercial property only while HBZ Bank uses this mode of financing for commercial and residential property, motor vehicles and equipment. Al Baraka and FNB finance both commercial and residential properties under diminishing *Musharaka*.

As *Musharaka* is a form of partnership, where both the bank and the customer make contributions to the partnership but only the customer uses the asset of the partnership. Included in this agreement is an undertaking by the customer to purchase back the bank's share of partnership and ultimately become the sole owner of the asset. This repurchase is usually structured in instalments over a number of years:

> So in the [diminishing] *Musharaka*, what happens is that, say the property is R10 million and we [the Islamic bank] tell you we want a deposit of 20 per cent, so that R2 million becomes your [the customer's] equity in that property, so you [the customer] own 20 per cent and we [the Islamic bank] own 80 per cent and we [the Islamic bank] would fund the 80 per cent of the property, so we [the Islamic bank and the customer] are in a partnership on the property. We [the Islamic bank] would follow the normal process in terms of registering a bond and all of that because that's the normal requirements. (R3)

> Over a period of say 20 years the 80 per cent that the bank owns will be sold to the individual [customer]. In the first year you [the customer] own 20 per cent the bank owns 80 per cent. Assuming the bank sells you [the customer] 8 per cent a year, the second year you [the customer] own 28 per cent, the bank owns 72 per cent, the third year you [the customer] own 36 per cent the bank owns 64 per cent etc. and it that way over a period of time the house ownership goes to the individual [the customer], that's how diminishing *Musharaka* works. (R1)

In South Africa, Islamic banks use different methods to facilitate the buy-back of the shares by the customer. At ABSA and HBZ Bank, through a series of contracts, customers buy back the Islamic bank's share of the partnership at a cost, i.e. at the original value of the asset. In this instance, Islamic banks earn returns on diminishing *Musharaka* transactions through charging a rental to the customer for use of the bank's share of the asset. In the example quoted by (R1) above, the bank would charge the customer a rental for 80 per cent of the property occupied by the customer for the first year, rental for 72 per cent of the property in the second year and rental for 64 per cent of the property in the third year and so on:

> There are 3 agreements, the one is the *Musharaka* the partnership [agreement] the initial [agreement], then we have an undertaking to purchase which basically says we [the Islamic bank] don't want to hold on to the property, that's not our business and you [the customer] would undertake [to repurchase the bank's stake] monthly or quarterly or however the payments are structured and that will be done at cost. So over the term, every month you [the customer] will repurchase the equity until you [the customer] own 100 per cent and we [the Islamic bank] own 0. Then [The last agreement] we [the Islamic bank] charge you a rental in proportion to our holding. (R3)

> [So diminishing *Musharaka* uses *Ijarah* principles as well? And only for the capital you use *Musharaka*?] Diminishing *Musharaka* [is used] on the capital side and *Ijarah* [is used] on the rental side. (R7)

Al Baraka Bank and FNB, on the other hand, sell the bank's equity stake at cost plus a mark-up once a year, in equal instalments calculated by dividing the Islamic bank's equity stake to be sold over the period of the contract. Using the example cited by (R3) above (for a property worth R 10m, the Islamic bank has an 80 per cent equity stake and the customer has a 20 per cent stake); if the contract is over 10 years, the bank will each year, at the anniversary of the contract, sell 8 per cent of its equity stake. Each year, at the anniversary of the contract, the profit mark-up on the equity stake instalment to be sold in the next year is agreed. Profit mark-up may therefore vary year-on-year. For example, an 8 per cent equity stake sold by the Islamic bank in year one may be at a higher or lower amount than the 8 per cent equity stake sold in year two:

> […] you [the customer] sign a diminishing *Musharaka* agreement. So a diminishing *Musharaka* agreement states that you will have use of the house. There are quite a few things in terms of the use agreement; what you [the customer] are allowed to do, what you [the customer] are not allowed to do. Also the agreement would say over a specified amount of time depending 5,10, 15 20 years, up to 20 years maximum, you can purchase the banks interest in the property back over that period of time in equal chunks or it's up to you. At the end of the 1st year, it's based on a 1 year fixed period; we will sell you maybe another 10 per cent, depending on the term, at a mark-up. So other banks when you rent the house, there's a rental component and a resale component, we cut out the rental component, we just sell you back the share at a mark-up. [So then you [the Islamic bank] are using *Murabaha* principles?] Its *Murabaha* entwined in a diminishing *Musharaka*. (R6)

Similar to *Ijarah* financing discussed above, the rental charged in diminishing *Musharaka* agreements is based on standard amortisation tables as used in conventional banking as opposed to actual rental values the asset would generate:

> When we actually draft our lease amortisation schedules, we specifically draft it in such a way that it actually accommodates the Islamic contract. So what we do, we actually assign R1 equals to 1 unit so whatever capital you [the customer] are paying off, it actually shows that this is the repurchase of units on diminishing *Musharaka*. And whatever rental portion or interest portion in conventional terms is the rental allocated to those leftover capital units. (R4)

Likewise, the profit mark-up charged by the Islamic bank on sale of *Musharaka* shares to the customer is based on financing principles and returns payable to depositors rather than the appreciation of the value of the asset since the original agreement:

> When we [the Islamic bank] are taking your [the *Mudarabah* depositors'] one year funds from you [the *Mudarabah* depositor], we [the Islamic bank] are not promising you [the *Mudarabah* depositor], but we [the Islamic bank] are giving you [the *Mudarabah* depositor] an indicative rate on what one year returns will be. So when we [the Islamic bank] are funding the one year on the other [diminishing *Musharaka*] side we [the Islamic bank] need to make sure that we [the Islamic bank] are able to generate the profit to give you [the *Mudarabah* depositor] the return. So we [the Islamic bank] take all of those factors into account when we are selling [marking-up] our stake in the [diminishing *Musharaka*] property. (R6)

Diminishing *Musharaka* transactions are early settled when the customer buys back the banks' full share earlier than originally contracted for. Islamic banks that facilitate repurchase by the customer of the Islamic bank's share at cost, allow more flexibility and allow early settlement at any stage during the contract at cost. The resulting rental ceases as the Islamic bank no longer owns any shares in the asset:

> [If the customer wishes to purchase the banks entire share two months into the contract? No problem, we [the Islamic bank] [will] take the rental for the two months [that the asset was partly owned by the Islamic bank] then you [the customer] pay back the principle [at the original cost of the asset]. (R7)

Early settlement of diminishing *Musharaka* transactions where the Islamic banks resells the equity stake at a mark-up may only happen once a year at the anniversary of the contract. Equity sold to customers over the annual prescribed repurchase percentage (8 per cent in the example above) is at cost and does not carry a mark-up:

> So we [the Islamic bank] are entitled to our year's profit that we [the Islamic bank and customer] agreed upfront already. So remember, the diminishing *Musharaka* contract in year one, we enter into an agreement where over the year you [the customer] are going to buy back only [the prescribed] 8 per cent share at a mark-up. We [the Islamic bank] don't enter into an agreement to say the rest of the years what that mark-up price is. So as a[n] [Islamic] bank we can sell that to you at any rate going forward. But we [the Islamic bank] give you an indication that during the term of the loan your

rate will be the Islamic base lending rate plus a profit mark-up. So we can sell it to you at just the Islamic base lending rate, it's very flexible. So we give our customer a lot of flexibility.

6. Discussion and conclusion

Respondents interviewed as part of the study emphasised that Islamic banks have implemented controls around, and regularly review, the legal structure of Islamic banking transactions in South Africa for compliance with the *Shariah* law. At the same time, most respondents agree that Islamic banking in South Africa does not present an alternative banking experience but rather replicates conventional banking. The findings further indicate that each of the South African banks has innovated Islamic banking products so as to maintain the *Shariah*-compliant structure and comply with the regulatory and legislative requirements of banking in South Africa.

In terms of *Shariah*, *qard* transactions are loans granted to someone in need; however, economically, depositors are not loaning their money to Islamic banks due to the banks' needs but rather as a mechanism for keeping money safe and for facilitating electronic transactions. Similarly, *Mudarabah* in *Shariah* is an equity investment in the business of a bank; however, depositors merely use this platform as a convenient way to earn returns without having to do the level of research equity investors would perform before investing their money. In turn, the Islamic banks, while not guaranteeing *Mudarabah* depositors' funds, structure the banks operations so as to ensure that losses of those funds are highly improbable, all of which indicate a relationship other than that of an equity investment.

Murabaha and *Ijarah* transactions are trade transactions under *Shariah*, which imply short repayment terms (three months or less). Islamic banks, however, use these transactions for long-term financing (three to seven year terms). Islamic banks ordinarily do not engage in trade and apply rates of return as the profit margin on these transactions rather than applying the market value of the product being traded. The period of the transaction and the application of the profit margin result in the economics of *Murabaha* and *Ijarah* transactions not being analogous to its legal form and instead resembling conventional financing transactions.

Diminishing *Musharaka* transactions are a partnership in terms of *Shariah*, but are used as a method of financing by Islamic banks. As this mode of financing is used mainly for owner-occupied commercial and residential property, the partnership itself is not operated as a business, earning its separate profits which are then split between the Islamic bank and the customer. Islamic banks base profits charged to customers on these transactions (either through *Murabaha* or *Ijarah*) not on property value or rental prices prevalent for other properties in the area but rather on the bank's required rate of return.

In conclusion, respondents were unanimous, in that preference was granted to the legal and contractual structure of Islamic banking transactions to meet *Shariah* requirements without a matching consideration for its economic substance. There seems to be an element of lethargy in addressing this lack of consideration, with none of the respondents interviewed viewing the significant difference in economic substance and legal form as a pitfall of Islamic banking or an area needing improvement. The overriding view was that legal structure and economic substance do not necessarily demand the same answers and are, in fact, independent of each other.

This study is the first of its kind in South Africa. The study adds to the Islamic banking literature by analysing the real execution of Islamic banking transactions rather than the theoretical compliance with *Shariah* law.

7. Limitations

While safeguards have been used to ensure the reliability and validity of the research, there remain a few inherent limitations which should be noted:

- Interviewees, while chosen for their expertise and level of knowledge, may provide highly technical insight which may be difficult to interpret. Detailed technicalities were therefore excluded from this research.
- The regulatory environment of banks in South Africa, for example, regulation imposed by the Financial Service Board on all financial institutions in South Africa, has not been explored. However, the regulatory environment was brought to the readers' attention to help illustrate certain themes.
- This research uses only *Shariah* requirements as detailed in Section 2.2 to analyse transactions. *Fatwas* (rulings) issued by the *Shariah* Boards of South African Islamic banks have not been included in this study and may be an area of future research.

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