



**OXFORD ISLAMIC FINANCE- DAR AL-ISTITHMAR**

# Innovating Islamic Plastic

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## A Value Added Socially Responsible Alternative

**Sayd Farook**

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This product development white paper outlines a new innovative credit card concept linked to behavioural trends of the credit card user. The paper reviews the ethical and religious issues associated with conventional credit cards, provides an overview of existing Shari'a compliant credit cards and finally puts forward a proposal for an innovative credit card application that serves the needs of the user while remaining profitable for financial institutions. The alternative structured credit card proposed here links savings behaviour with credit extension incentives, thereby truly establishing a value added Shari'a based solution serving both the objectives of the Shari'a while benefiting all parties concerned.

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## 1. Introduction

Most Islamic banks carry at least one credit card product. Yet many Islamic bankers will tell you that the Islamic credit card business is not as profitable as conventional credit card business...and if it is offered, it's only to complement their other products and achieve cross-selling objectives. On the other hand, some might be just as profitable as conventional credit cards, but in the process of doing so, push "Shari'a arbitrage" to its limits with substantial manipulation of the credit card 'form'. This study provides review of the need for 'Islamic plastic', the available Islamic alternatives in the market and assessing whether any of these provide any economic value or social value. Finally, the study recommends a new type of credit card which is substantially aligned with Islamic principles (Shari'a based) while providing economic and social value to both the card user and the issuer.

## 2. The ethical and religious issues with conventional credit cards

Conventional credit or charge cards profit on the concept of an interest rate, calculated based on the extent of credit actually extended to the customer. While there are interest-free periods ranging from 45-60 days and credit card providers charge an interchange fee approximating around 1.5-2 percent, most make their substantial profits during the period subsequent to the interest-free period when they charge high interest rates on a daily basis (sometimes up to 29%).

Hence, it is naturally in the interests of credit providers to extend credit to the customer beyond the interest free period. Indeed, the credit card is one of the most profitable business lines for banks nowadays.

Bankers will provide a number of justifications for the exorbitant interest rates, the first one on the list being the high risk exposure associated with the unsecured credit risk of each customer. One could argue that banks do not reduce the interest rates for customers who have a good credit track record. Hence, the exorbitant interest rates do not really reflect the credit risk of the customer. Bankers may also cite the capital adequacy charge of unsecured lending practices as one of the reasons.

Regardless, the conventional credit card presents a number of problems, from both an ethical and religious perspective.

It is no secret that bankers pry on financially ignorant customers to ensure that they utilise their credit beyond interest free periods. These customers enter into agreements with credit card providers on the basis that the credit facility might help them manage their liquidity better or provide some cushion in times of liquidity shortage or mismatch.

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True, the credit card does provide such liquidity management or cushion if used efficiently. The problem is that the majority of customers are not aware of the downside risks associated with paying the credit card off a little later, because of their relative financial ignorance compared to financial institutions. Hence, millions of customers keep on living and extending themselves beyond their means based on their credit facilities.

Financial institutions, on the other hand, have no incentive to disclose the dangers of credit cards to their financially unaware customers, for fear that this might affect one of their most profitable lines of business.

The magnitude of this problem has ballooned as of late. If one reviews the personal debt levels in countries with developed financial systems such as the UK, United States or Australia, it is evident that individuals are stretching their financial limits. For instance, the personal debt levels in the UK passed above the total GDP (1.33 trillion pounds) of the country in 2007 to reach 1.35 trillion pounds, according to a report by Grant Thornton. Among the personal debt, personal loans and credit cards spiralled to a staggering 214 billion while mortgage debt rose to 1.131 trillion. What this essentially implies is that people in the UK were for the first time owing more to the banks than the value of all products and services produced in every factory or office in the country, or in other words, living beyond their productive means. The figures are a lot worse for Australia (where personal debt is 156% of GDP) and the United States (more than 180% of GDP). In most of these countries, personal debt to income ratios are somewhere near 170% meaning that individuals on average owe 70% more than what they earn in a year. And that is just the average over the whole population, which means that there are many who owe a lot more. While this may be total personal debt, the share of personal loans and credit cards are increasing by the day, as families struggling to pay their mortgages offload some of the pressures onto their credit card.

Encouraging consumption spending in such an explicit manner, without providing for financial education, is therefore a serious ethical question that should be raised to all credit card providers in those economies. The worst part is, just like tobacco companies, credit card providers move to greener pastures in search for profitable and credit worthy exploits such as the emerging markets of GCC, India, China and South East Asian regions.

In addition to the general ethical dilemma associated with consumption based credit, credits cards pose serious Islamic religious restrictions. For one, credit cards charge interest based on the amount of credit extended to the client. For the majority of Islamic scholars, this represents unacceptable usury, the consensus definition of which is an increase on money lent. Some would argue that the interest rates on credits cards are so high that all Islamic scholars would define this form of lending as usurious, regardless of their school of thought.

### 3. Existing Islamic Credit Cards in the market

Regardless of the ethical and religious issues presented by credit cards, they still provide an innovation in the market that caters to a genuine need: the need for emergency liquidity or for liquidity mismatches, just like a mobile phone provides a means for customers to call people in times of emergency from anywhere in the world. In the absence of a strong social network (which is dwindling by the day), credit cards provide a mechanism for people to borrow short term to pay for their daily needs.

Hence, Islamic customers rightfully demand such sorts of product to manage their liquidity needs. To circumvent the restrictions on *usury*, Islamic banks have come up with a number of interesting credit card products, some original and some dubious. The major restriction on Islamic credit cards is that they cannot impose any charges whatsoever based on the extent of principal owing. So how do Islamic banks make Islamic credit cards viable as a profitable line of business? Of course there are other alternate ways in getting profit besides charging interest or fee for the extension of a credit facility to a customer. In Islamic banking, these alternates are based on certain Shari'a nominate contract models. All of these models have one similarity in that its profit rate, or the fee charged upon the customer is fixed and transparently known from the beginning. Unlike its conventional counterpart, where the interest charged on the customer will vary from customer to customer depending on the time pattern of the credit instalment, Islamic credit cards make customers pay a contractually binding fixed amount. Another distinguishing feature is that the underlying reason of charging a fee or an extra amount in addition to cost is not because of credit extension but because of reasons of maintenance or serviced provision, depending on the type of Shari'a nominate contract used.

The majority of credit card products in the market are based on four Shari'a nominate contract models, which are listed below:

1. Bai Al-Ina (Buy back finance based)
2. Tawarruq (Cash finance based)
3. Ijarah (Lease based)
4. Ujra (Fee based)
5. Kafalah (Fee for guarantee)

The Bai Al-Ina and Tawarruq based models essentially utilise Islamic legal stratagems to extend a line of credit to customers, through executing a number of sales with the customers. The Ijarah card in its operational resemblance is closest to a conventional credit card, while the Ujra and Kafalah card are viewed as being closest to Shari'a principles. The structures of all of these models are explained below.

### 3.1 Bai Al-Ina credit card structure

The Bai Al-Ina model is mostly used in the South East Asian region, more specifically Malaysia, as its pioneer. Examples of these credit cards in the industry would be the Bank Islam Card (BIC) issued by Bank Islam Malaysia Bhd. and the Al-Taslif credit cards issued by Am Bank, a Malaysian based conventional bank with an Islamic window.

In Bai Al-Ina based credit cards, the bank engages in a number of contracts with the customer in several stages:

- Stage 1. In the first instance, a piece of land owned by the bank is sold to the customer at an agreed price through instalments for a certain period of time whenever a customer Islamic credit card application is approved.
- Stage 2. The bank then re-purchases that same piece of land from the customer at a lower price, where the amount acts as the credit limit.

The difference between the higher price paid by the customer and the lower price paid by the bank is the maximum profit that can be charged by the bank. Comparatively, this is more transparent than conventional credit cards since the maximum profit that can be charged for the period is fixed and known to the customer.

- Step 3. The bank disburses the proceeds of the sale of the land owned by the customer to a Wadiah (safe custody) account maintained by the bank.
- Step 4. This account provides the cash from which the customer can withdraw funds or pay for purchases just like conventional credit cards, the difference being that there is real cash backing up the credit facility.

Besides paying the instalments of the purchase of the land, the customer also pays a certain amount of management, equivalent to the annual membership fee of a conventional credit card.

The figure below shows an example of Bai-Al Ina credit card structure.

Stage 1: Bank sells customer piece of land for deferred payment for price equivalent to credit limit + total profit (subject to credit approval).

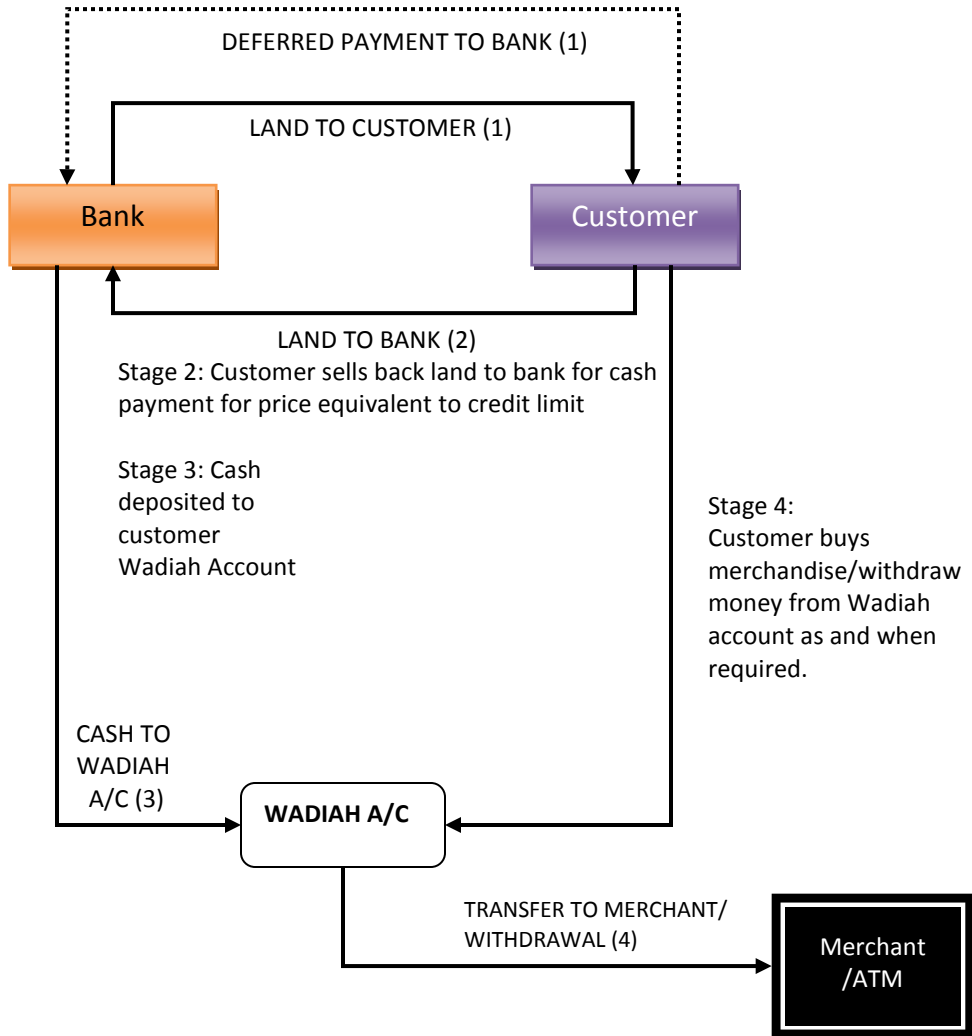


Figure 1. Bai Al-Ina based credit cards as practiced in Malaysia

### 3.2 Tawarruq credit card structure

The Tawarruq model used in Islamic credit cards is a response towards the earlier implementation of Bai Al-Ina. Widely used in the Middle East, Tawarruq has one significant difference compared to Bai Al-Ina. Instead of retaining back the sold commodity from the client, the Islamic bank has another third party or parties to replace its role as a buyer. This third party is often called as the commodity broker and is already arranged by the Islamic bank. Just like the Bai Al-Inah based credit card, the

proceeds from the sale are also channelled to an account of the Islamic bank, usually a Wadi’ah. A simple structure is shown in Figure 2.

Examples of the usage of Tawarruq are the products of Saudi Arabian banks: National Commercial Bank Arabia (Al Tayseer Al-Ahli) and Arab National Bank (Al Mubarak) respectively.

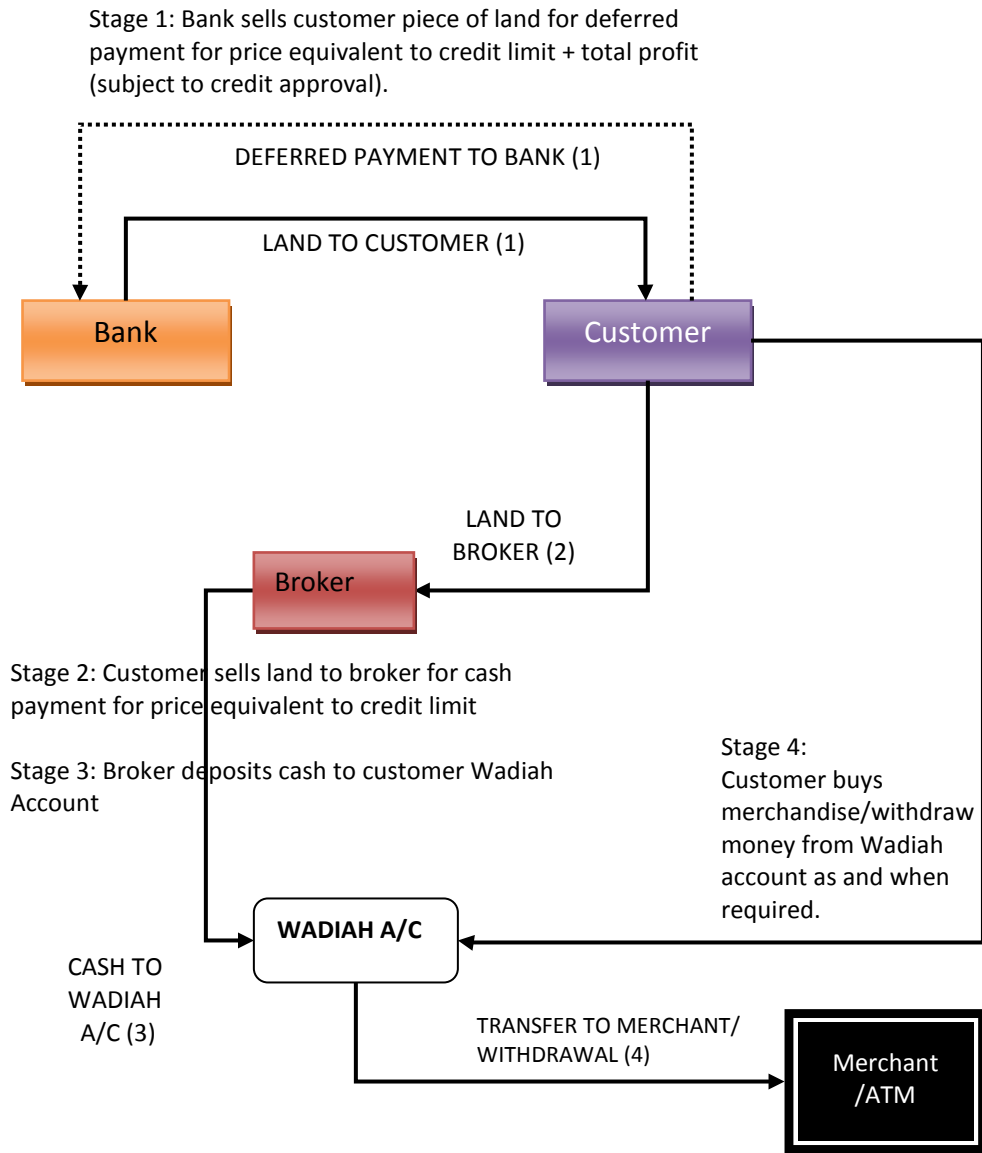


Figure 2. Tawarruq-based credit cards as practiced in Saudi Arabia

### 3.3 Ijarah credit card structure

The Ijarah based credit card is seen as a better alternative compared to the Bai Al-Ina and Tawarruq credit cards that have many criticisms surrounding their existence. Initiated by Kuwait Finance House (KFH) in the form of the KFH Ijarah card or the recently launched baytik, it allows the cardholders to acquire durable goods on a 'lease-to-own' (Ijarah Muntahia Bit Tamleek) transaction from certain stores that have a cooperative existing relationship with the Islamic Bank. When a customer purchases the goods, he or she acts as a representative or wakeel of the bank, so a wakalah contract also implicitly exists. At the time of purchase, ownership is with the Islamic bank, but after a certain period of time, the ownership is transferred to the customer. This will depend on the type of ownership transfer that is used in the Ijarah.

Ijarah based credit cards can be interpreted as an Ijarah Muntahia Bit Tamleek transaction between an Islamic bank and a customer with simplicity of a card where there must be an underlying asset involved in the transaction. All of the Islamic jurisprudence principles and rules in an Ijarah would apply to an Ijarah based credit card. For example, the type of goods that can be the subject of an Ijarah must be of the non consumable (isti'mali) or durable type because the transfer in an ijarah is initially a usufruct transfer which does not involve the transfer of the whole thing including the corpus.

Figure 3 provides the transaction structure of the Ijarah based credit card.

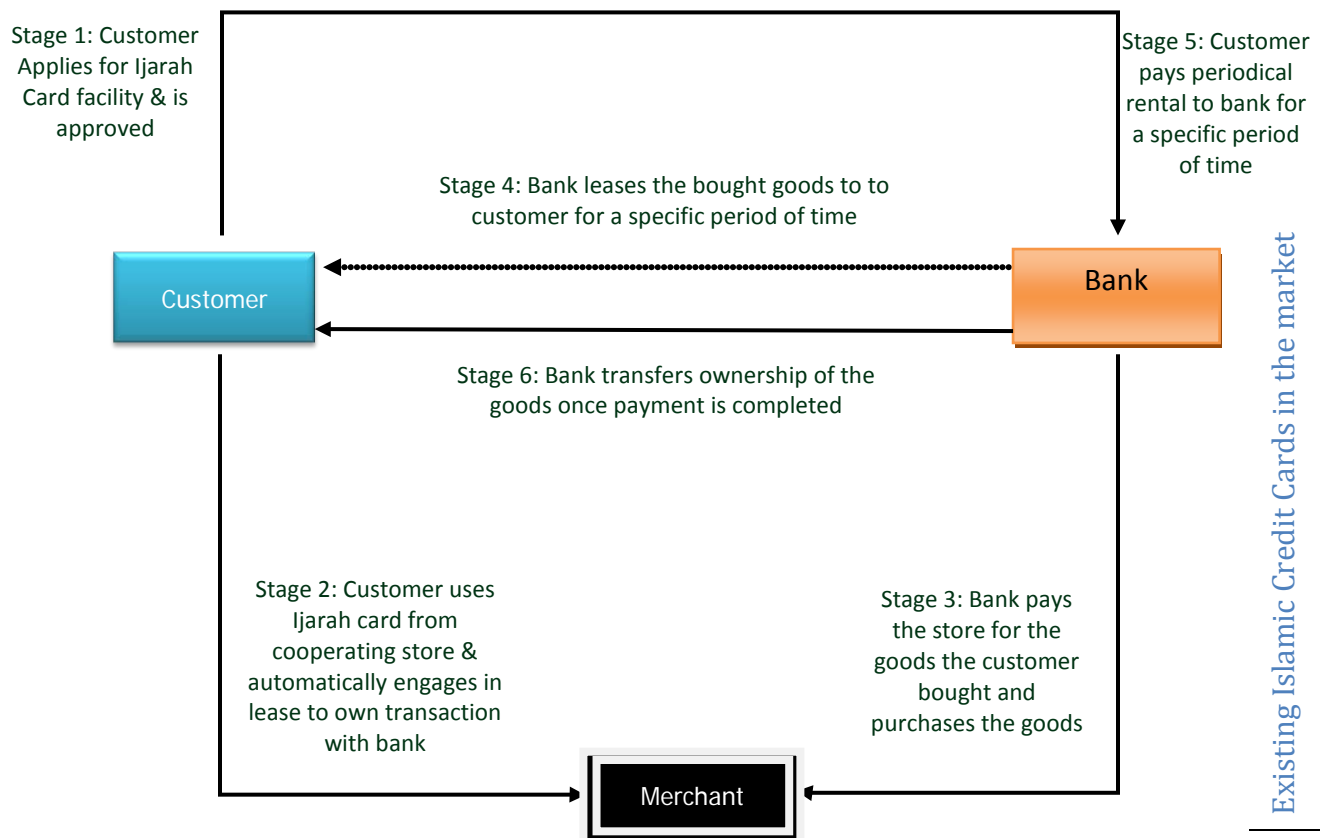


Figure 3. Ijarah based credit card as practiced by Kuwait Finance House (Baytik Card)

### 3.4 Ujrah credit card structure

Ujrah or fee based Islamic credit cards were first implemented in the Skywards Emirates Islamic Bank (EIB) credit card issued by Emirates Islamic Bank of the UAE. This was later followed by the Al-Islami credit card and Islamic Visa card (Al Tayseer credit card), issued by Dubai Islamic Bank and Kuwait Finance House respectively.

Islamic credit cards that use the Ujrah model can be regarded as the simplest form out of all of the other structures that are currently being used. In essence, the Islamic bank guarantees the payment of customer's purchases and charges a fixed fee for this service. Therefore, the Islamic bank relies purely on maintenance and service fees (such as annual membership fee) charged to the customer and the cards do not involve any stratagems, as do Ijarah or Tawarruq based credit cards.

The Ujrah based card lets customers spend beyond their available cash, where technically the Islamic bank purchases the item for them and pays the vendor. The customer is indebted to the bank for the purchase amount which is provided as a Qard ul-Hassan. The Islamic bank charges a yearly or monthly maintenance fee for the Islamic credit card service or for letting customers hold an outstanding balance on the card and fees for certain services such as request of credit card statement or cash advance. Because the Islamic bank does not put any mark up on any purchase transactions executed by the customer as in the case of murabaha or ijarah and of course no interest is charged, the maintenance and service fees are considerably higher than the usual fees present in other types of credit cards, both Islamic or conventional. However, just like the other structures for Islamic credit cards, these fees are fixed and are transparently known by the customer from the beginning. Any variable additions in payment would only exist whenever the Islamic bank has a late payment fee clause, the proceeds of which can only be directed to charitable purposes.

Due to its high fixed fees, the Ujrah based credit card would be most beneficial for the type of customers who regularly use their card and like to carry their balance to the following months and spread payments, also known as revolvers. This also goes for other Islamic credit card structures because there is no such thing as a grace period, which is present in the conventional counterpart. No matter how quick a person pays off the balance, he will still be charged the same fixed fee that is paid in deferred instalments. In practice, a number of institutions offering Ujrah cards do provide fee refunds to clients, if the clients do not utilise the service.

Figure 4 displays the structure of an Ujrah credit card.

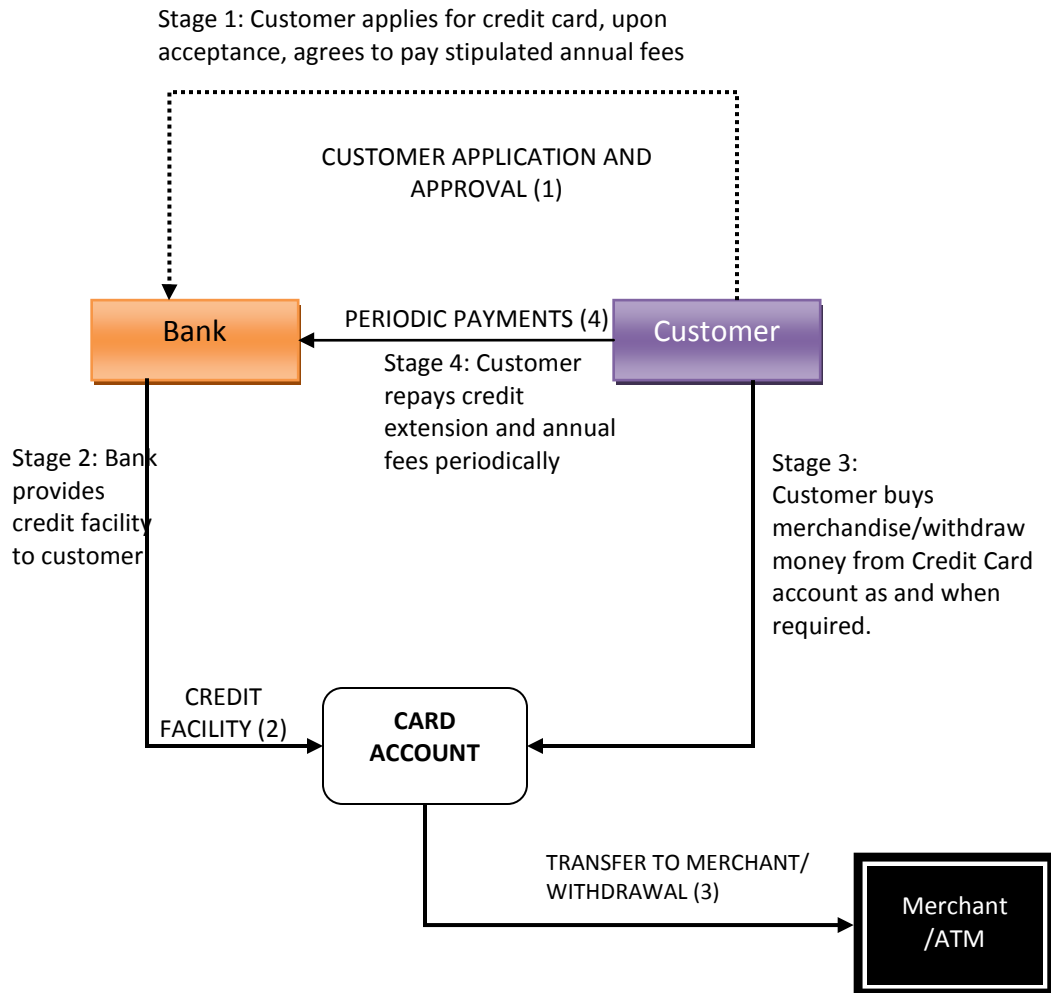


Figure 4. Ujrah-based credit cards

### 3.5 Kafalah credit card structure

The Kafalah based model employed by Shamil Bank in Bahrain is structured around the fee for guarantee or assurance concept. Under the Kafalah concept as employed here, the bank is entitled to charge a fee to guarantee payment to the vendor. In conceptual terms, the Kafalah is a hybrid between the Ujrah structure and the Tawarruq/Bai' al-Ina structures, since it charges a fixed fee on every purchase, while some variations may also charge a nominal annual fee (e.g. Gold cards). The Bank pays the vendor, subsequent to which the customer is obliged to repay the outstanding debt to the bank within a twelve month period.

The fee structure is flat and is therefore useful for those who would like to purchase items on instalment. However, it is not convenient or cost effective for customers who like to repay their full facility on a monthly basis, since the flat fee percent (for example

6.5 percent) is charged regardless of however many days or months over which the customer withdraws the funds. In terms of its Shari’a substance, one could argue it is also closely aligned with the substance of Shari’a compliance, since it encourages people to only purchase goods that are required on a long term basis (as opposed to consumables). Nevertheless, while its fee structure provides incentives for purchasing non-consumption spending, it does not necessarily stop customers from utilising it for deferred payment consumption spending.

Figure 5 displays the structure of the Kafalah credit card.

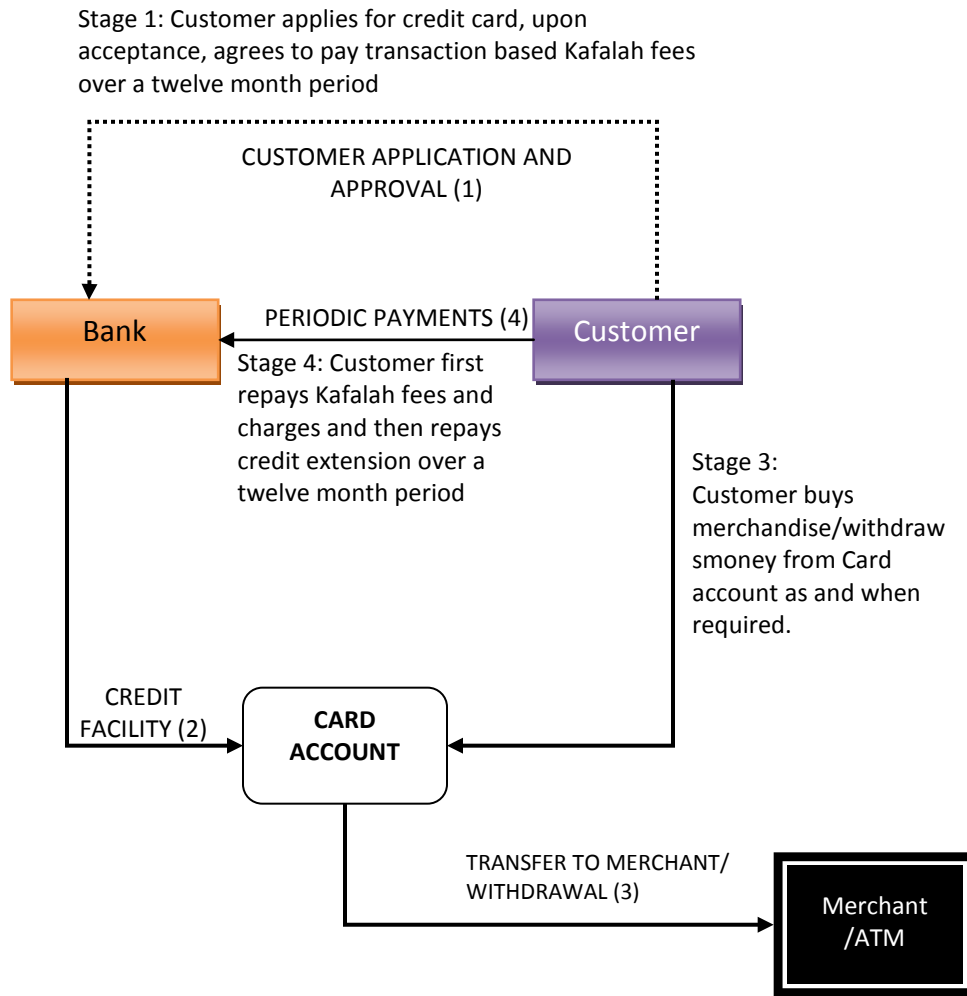


Figure 5. Kafalah credit cards

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**Table 1 Comparison of credit cards offered in the market**

	Conventional	Bai Al-Ina	Tawarruq	Ijarah	Ujrah	Kafalah
<b>Revenue Generation</b>	Interest on outstanding	Mark-up on sale	Mark-up on sale	Rent of usufruct	Fee for service facility	Fee for guarantee
<b>Return linked to tenure</b>	Yes	No	No	Yes	No	No
<b>Late Payment Fees</b>	Yes	Yes (charity)	Yes (charity)	Yes (charity)	Yes (charity)	Yes (charity)
<b>Over limit fees</b>	Yes	No	No	No	No	No
<b>Types of Assets</b>	Anything including cash	Permissible assets including cash	Permissible assets including cash	Non-consumable assets	Permissible assets including cash	Permissible assets including cash
<b>Cash Advances</b>	Additional charge and higher interest rate	Yes	Yes	No	Fixed charge for cash advances taken in first instalment	Same charge as asset purchase
<b>Shari'a Compliance</b>	Impermissible	Malaysia Only	Compliant (Saudi Arabia)	Compliant	Compliant	Compliant
<b>Shari'a Substance</b>	Impermissible	Dubious	Dubious	Acceptable	Preferable	Preferable

#### 4. Issues with existing Islamic credit cards in the market

The issue with existing Islamic credit cards is that the majority of them attempt to replicate the effects of conventional credit cards. Where they don't replicate conventional credit cards and attempt to remain true to Islamic principles, they forgo profitability or features. Many critics of Islamic credit cards cite the high fees associated with Islamic credit cards, which are only useful for revolvers, or those who consistently utilise the bank's credit (see article in appendices). Regardless, there is too much nomenclature and too little innovation in the Islamic credit card space.

Islamic credit cards do not necessarily offer a differentiated value proposition to customers. All types of rewards programs, cash back offers, insurance and access to lounges have existed for long enough in the conventional space. In fact, they are not doing anything to reduce the reliance of customers on credit for consumption spending. While Muslim countries have not reached the debt laden levels reached in the developed world, it is likely that they will become credit hungry as financial systems develop, competition intensifies and banks start offering increasingly larger credit limits. This was exactly the concern raised by Sh. Isham Ishaq at the Annual AAOIFI conference held in Bahrain in 2007. He believes that engaging in the credit card space in the same terms as conventional banks bring the Islamic Finance industry to the same outcomes as the debt ridden consumerist and materialistic societies of the developed world.

The problem with the existing cards in the credit card market is that all the features are directly or indirectly aligned to increasing the debt of the customer. For instance, card users gain reward points for increased use of the card. In addition, they gain additional points for selected locations, all of which can be utilised for plane tickets, gifts based on their usage of the credit card.

Credit card issuers will claim that their cards are neither positive nor negative; they are neutral. It is up to the card user to use it for her benefit or to her detriment. What they neglect to mention is that there is nothing stopping the card user from using it to their own detriment. Neither is it in the interests of the card provider that the card user stops using the card for certain detrimental acts such as exacerbating irresponsible spending, since this would lead to a decline in substantial revenues for the credit card issuer.

What credit card providers don't do and should be doing is telling their customers the ills of credit cards, much like how smokers are warned about the ills of their smoking every time they open a cigarette pack; often with grotesque pictures. Perhaps such warnings will only come with credit cards when the general public will reveal through media and other forms of communication, how the present use of credit cards are destructive to society and its objectives, such as the preservation of religion, life, family, wealth and security. Then the government may need to regulate the industry and rein in

the power of the banks to abuse the trust of customers. Alternatively, the banks will attempt to voluntarily regulate themselves in response to social pressure and in order to legitimise themselves. This is already occurring in most developed financial markets where credit card penetration is high.

So what are Islamic credit card issuers to do? Obviously, credit cards provide some real utility for customers for which reason they still exist and cannot be ignored from a legitimate needs based perspective, which Islam supports. There are two ways credit cards can be offered within Islamic and ethical constraints. One is to use the existing offering but provide more customer education in terms of proper credit card use. This is easily implemented within Islamic financial institutions with appropriate will power from the regulatory authorities.

The second is to devise an innovative product that aligns customers' incentive to utilise the card for valid and justifiable reasons, such as liquidity management, long term purchases and emergency liquidity. All of these can and should be provided within an Islamic credit card, without having to charge customers' exorbitant interest, fees or profits and still produce profits for the bank.

### 5. An incentive based ethical card

The question then becomes how to devise a credit card that doesn't charge interest, is ethical for all parties concerned, serves the interest of the Islamic consumer market and legitimately earns the Islamic bank a profit?

The model proposed below attempts to link savings and credit card behaviour, with amount and tenure of credit increased commensurate with the savings behaviour of the individual.

The model is premised on the relationship based banking system, where customers are attracted and retained for long term relationships rather than on a transaction basis.

Since savings and growing one's legitimate wealth is encouraged in Islam and is overall beneficial for the security of human beings, linking savings behaviour with credit spending would definitely be considered as a good end for Shari'a scholars. However, the means or the credit card product must also be Shari'a compliant.

Unless you are placing your funds for growing your investment, most savings and current account customers utilise their accounts for liquidity and safekeeping rather than the profits or interest generated which is quite minimal. Instead of paying out profits or interest to customers, if the customer were to be rewarded for every dollar saved with a proportionate increase in the tenure or credit limit of his credit card, it

would serve the dual purpose of helping the customer save and at the same time, increase his available credit in case he needs it.

A conceptual example will help to illustrate:

1. A customer is offered an interest free Shari'a compliant credit card by the Islamic bank. The bank charges the customer a fixed annual administrative fee for the use of the credit card, an amount somewhere near to what other banks charge. The customer only receives a credit limit around the range of his monthly salary. In addition, he must pay this amount off fully before a certain period, which could be 15-30 days after the month end.
2. As part of the offer, the customer can avail himself of a free wadiah based savings account with the Islamic bank (which pays no profit rate).
3. The Islamic issuing bank may also offer a rewards program linked with the interchange fee charge from the merchant on every transaction (which usually ranges from 0.75-2.00 percent).

Up to this point the cards are very similar to other Ujrah based cards. The difference is in the reward incentives provided by the card subsequently.

4. Depending on the average monthly balance in the customer's savings account, the credit limit of the account is proportionately increased, for instance by 1/10 of the average monthly balance. For instance, for an average monthly balance of USD 1000, the credit limit will increase by USD 100. Of course, the exact calculations of the credit limit will vary based on the bank's cost of funding. If the customer delays his payment on his obligations on any one month, the credit limit offered will be withdrawn to the higher of the original credit limit provided to the customer at the time of issuance of the card OR the credit limit available to the customer 12 months prior.

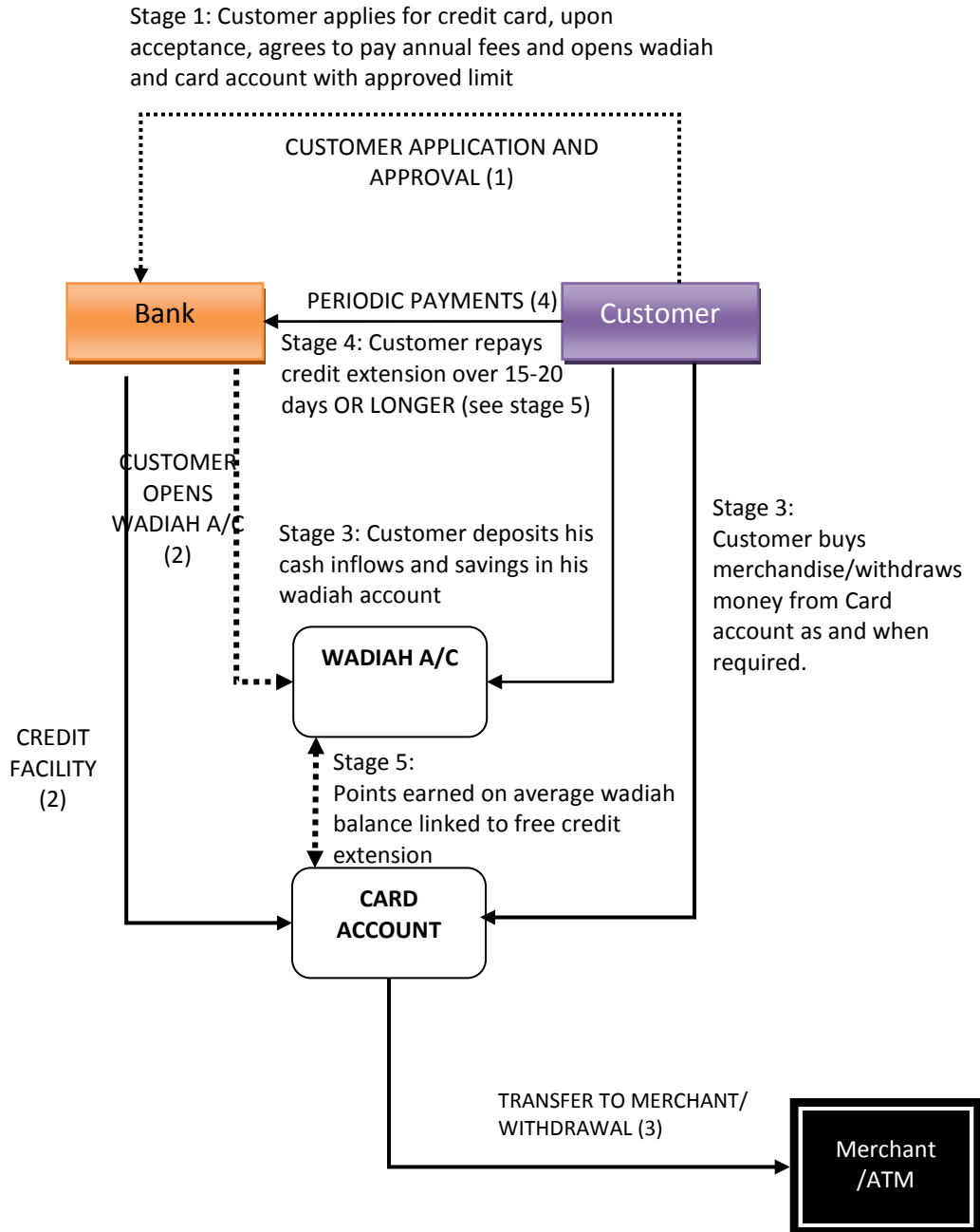
Up to this stage, the bank has not incurred any additional cost for offering this. Instead, the bank may get an increase in the average monthly balances available for investment cost-free. However, this may not be particularly appealing to clients since they may already receive credit limit increases if they request for it and they have a good payment record.

5. The additional and most attractive feature is the ability to delay payment on the outstanding amount depending on the average monthly balance calculation. For an average balance of USD 1000 for a month, the customer will be able to extend his own credit for six months for a multiple amount (for instance by 1/10 or USD 100. The customer may redeem this credit extension anytime after and this credit extension amount can grow based on his savings behaviour.

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This essentially means that the customer can slowly accumulate a line of credit to pay for big ticket items or for emergencies, without paying any interest or charges for that line of credit.

The structure for the incentive based credit card is provided in Figure 6.



**Figure 6. Incentive based credit card model**

## 5.1 Points System

The concept discussed above with respect to the extension of credit tenure can be translated into a points system to account for the relationship between the issuing bank and the customer.

Let us assume that the bank can only afford (if it seeks to be profitable) to provide 1/10 of the average monthly savings account balance to the customer as interest free financing for a five month period.

For every 10 dollar the customer deposits for a month on average, he/she will receive 1 point. This 1 point will be redeemable for interest free financing equivalent to 1 dollar for five months, i.e. he will have the right to borrow 1 dollar interest free for five months.

Let us further assume that the customer deposits an average monthly balance of USD 1000 for 2 months in a row, earning the customer  $1000/10 \times 1 \text{ point} \times 2 \text{ months} = 200$  points. This will enable the customer to withdraw or finance beyond the payback period 200 dollars worth of purchases for a period of six months.

## 5.2 Features

Every 10 dollars (Average monthly balance):

1. Earns 1 point, and
2. Credit limit is increased by 1 dollar.

Note: If the customer does not pay his financing within the stipulated payback period (15-30 days), the customer's credit limit is withdrawn to the higher of the original credit limit provided to the customer at the time of issuance of the card OR the credit limit available to the customer 12 months prior.

*Benefits for the customer:*

- Credit Limit is increased by average balance kept in the customer's account
- Customer has access to interest free financing (no strings attached) for 1 dollar for six months from purchase date.
- Customer can utilise access to interest free financing to finance the purchase of expensive big ticket items or hold it as a reserve as and when required for emergencies.

### *Benefits for the bank:*

- Can invest savings account funds for the benefit of the bank's bottom line, without paying savings account holders any financial return.
- Expense for funds received from savings accounts is 50 percent of total funds provided to bank cost free, i.e. for every 10 dollars of funds received cost free, the bank has to provide 5 months interest free financing for 1 dollar.
- Bank provides financing based on the savings behaviour of the customer over a period of time and can withdraw the financing privileges if the customer demonstrates alternative credit default behaviour (for instance, if the customer delays in his monthly repayment, his credit limit is decreased).

### *Risks and risk mitigants:*

- **Customer abuses his financing privileges and defaults beyond payback period:** credit limit is reduced to original amount and immediate recovery sought for outstanding balance.
- **General default by a certain percentage of customers:** this risk exposure is faced by all credit card issuers and can only be mitigated through diligent initial credit risk screening and ongoing credit risk.

### 5.3 Shari'a Compliance

The key Shari'a characterisations of this product are *prima facie* halal, i.e. providing interest free or *Qard al-Hasan* loan to the other party. However, some may raise the issue of the combination of benefit with a loan from the customer, if it is construed that the Wadi'ah based savings account is actually a loan. If such is the case, the customer provides safe keeping deposit to the bank and the bank in return provides the benefit of credit to the customer for specified periods of time. Some may argue that a loan that results in a benefit for the lender is prohibited as a result of Hadith of the Prophet (pbuh) where he forbade a sale and a loan in one contract<sup>1</sup> or he directly forbade any

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<sup>1</sup> Narrated by 'Abu Dawud, Al-Tirmidhi and Al-Nasai' on the authority of Abdullah ibn Amr ibn Al-As. There is also a narration with different wording in Al-Tabarani in his *Mu'jam* on the authority of Hakim ibn Hizam as follows: "The messenger of Allah (pbuh) forbade me from (1) combining a sale and a loan contract (2) combining two conditions in one sale, (3) selling that which I have not yet received, and (4) collecting returns without the commensurate risk": Al-Hafiz Al-Zayla'i (1<sup>st</sup> Edition (Hadith), vol. 4, p.19), Al-Haythami (vol. 4, p. 85) quoted in Wahba Al-Zuhayli (2001) *Al Fiqh Al-Islami wa Adillatuh* Dar Al-Fikr Damascus, Part 3, Chapter 12, p.376.

loan that results in a benefit (to the lender).<sup>2</sup> As a consequence of this Hadith, it was accepted as an all encompassing juristic rule.

However, the latter Hadith is known to be a weak tradition with a faulty chain of narration. Ibn Hajar, a prominent Hadith scholar stated that the chain of narration is weak.

Further, not every benefit in a loan is deemed forbidden. It could be argued that the benefit that accrues only to the lender is prohibited.

Instead, the benefit gained by the bank as borrower by borrowing for no cost is equal to or more than the benefit given to the (*customer*). In addition, it could be argued that the benefit that accrues to the lender (*customer*) does not result in any financial loss to the borrower (*bank*). In fact, if one is to consider the relative pay-offs, the borrower (*bank*) is better off in this respect, since this is how the bank makes profits.

Thus, both the bank and the customer are beneficiaries, without any harm imposed on the other party or any benefit at the expense of the other. In this regard, the prominent scholar ibn Taymiya stated that permissible mutual benefit is not necessarily forbidden:

*“there is no harm for a farmer to say to another: ‘help me to do my work and I will help you to do yours; you work with me today, and I work with with you tomorrow”*.

The idea of counter benefits for deposits was raised before in the context of time multiple counter-loans by late Professor Shaikh Mahmud Ahmed<sup>3</sup> and was presented in the report by the Council of Islamic Ideology:

"The concept of counter-loans, in essence, is quite simple and can best be explained with the help of an example: Suppose a small trader 'A' wishes to borrow Rs 100 from a bank 'B' for three months, free of interest. 'B' may provide the required loan to 'A' if the latter, simultaneously with receiving the loan, deposits a fraction of the loan for a proportionately longer period, says Rs 10 for 30 months. After three months, 'A' repays Rs 100 to 'B' but would pay back to 'A' his deposit of Rs 10 after the expiry of 30 months from the date of the deposit. During this period, 'B' can use this deposit or "counter-loan" for profit earning investment. However, just as 'A' would not be required to share

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<sup>2</sup> Narrated by Al-Harith ibn Abi Usamah in his *Musnad* on the authority of Ali ibn Ali Talib that the "Prophet (pbuh) forbade any loan that results in a benefit (to the lender)" quoted in Wahba Al-Zuhayli (2001) *Al Fiqh Al-Islami wa Adillatuh* Dar Al-Fikr Damascus, Part 3, Chapter 12, p.376.

<sup>3</sup> Professor Mahmud Ahmed Shaikh also presented the time multiple counter loan model in his seminal book: Mahmud Ahmad, Shaikh; *Towards Interest-Free Banking*, Institute of Islamic Culture, Lahore (1989).

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the income earned by him by deploying the loan provided by 'B', the latter would also not pay any additional amount when 'A's deposit (counter-loan) matures..<sup>4</sup>

The Council is of the view that it would not be correct to use this method by way of a permanent alternative system to the interest based system. However, if it is desired that provision may be made for providing personal loans to people of small means, then instead of the above stipulations, the banks may adopt it as a principle that they would provide loans for personal and non-productive purposes only to those persons who already hold accounts with them. In laying down the repayment schedule and the amount of the loan, however, the banks may keep in view the amount of the deposit of the applicant for the loan and the period over which he has maintained his deposit with the bank.”

The CII's parameters fit perfectly in line with the parameters of this credit card product:

1. providing personal loans to people of small means,
2. for personal and non-productive purposes,
3. only for persons who hold accounts with the bank,
4. bank may keep in view the amount of the deposit of the applicant for the loan and the period over which he has maintained his deposit with the bank.

There are further *fatawa* in support of the counter benefit concept. For instance, a fatwa from the Shari'a supervisory board of Kuwait Finance House permits a borrower to take a loan now in return for giving an interest free loan later on to the lender.<sup>5</sup>

Finally, it could be argued that the default ruling for commercial transactions, where there is no explicit ruling, is permissibility. Further, given the socially responsible Shari'a based objectives of such a credit card (i.e to promote savings and discourage credit abuse), it should be classified as something that is deemed to be good. Therefore, in this context, those who seek to prohibit this type of product must provide proof, since there exists no explicit prohibition in this case.

The utilisation of counter-loans/credit has also been approved for other necessary areas of Islamic finance, including that of liquidity management for Islamic Financial Institutions (IFIs). A recently approved structure utilised by Global Commodity Finance Ltd utilises a central register (“the Gate”) to record the amount, duration and rate lend by banks to each other in the form of points. IFIs earn points every time they lend

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<sup>4</sup> Council of Islamic Ideology (1980), “Report on the Elimination of Interest from the Economy 1980”, 15 June 1980, *Council of Islamic Ideology*, Islamabad, Pakistan. The time multiple counter loan scheme was suggested by Professor Mahmood Ahmed Shaikh in 1978-79 while he was a member of the “Panel of Economists and Bankers” set up by the Pakistan's Council of Islamic Ideology, a statutory advisory body working in Pakistan, for preparing Pakistan's financial system for transformation to Shari'a compliant parameters.

<sup>5</sup> Kuwaiti Finance House Fatwa no:162 (page 240 of Fatawa Al-Khidmaat- al-Masrafiah) : Question No:4 – Is it permissible that I take loan of 1000 Dinars for one year on the condition that I give a loan of 3000 Dinars to you for one year? Answer:- It is permissible

(positive) and lose points (negative) every time they borrow, the points being the register for the benefit accrued to the party lending. This is very similar to the concept utilised herein, where points form the basis of credit granted to the customer, and no direct and enforceable monetary benefit passes to the customer as a result of depositing with the bank. The Gate system was approved by three prominent scholars including Sh. Nizam Yaquby and Sh. Dr. Mohamed El-Gari and Dr. Mohammad Al Olama. While the majority of treasury transactions by IFIs are still conducted through Murabaha/Tawarruq modes of financing, the Gate system provides a Shari'a based solution that serves the interests of the parties while still being a clean transaction concept. Similar in many features to that product, the Islamic credit card proposed here aims to assist customers with short term financing, while indirectly providing incentives to the customers to save. In this respect, it is naturally a socially responsible product as defined by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) "Governance Standard for IFIs No. 7: Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions". This standard encourages IFIs to create policies to assist customers to save. Indeed, to protect and save one's wealth is considered an objective of the Shari'a and should determine, in the event no explicit ruling is evident whether a product or transaction should be permissible.

### 6. Conclusion

This product development white paper provides the motivation and structure to develop a new incentive based ethical credit card based on savings behaviour incentives. The study outlines the ethical issues associated with credit card use, details the types of Islamic credit cards available in the market and the motivation to find an alternative type of credit card. The study subsequently provides an illustration of an alternative structured credit card that links savings behaviour with credit extension, thereby establishing a truly value added Shari'a based solution that is likely to yield benefits for all parties concerned. Finally, the study provides an outline of the reasons why the product is considered Shari'a based in both form and substance. In terms of form, the benefits of the savings do not only accrue to the customer, but to both parties since the bank gets to borrow cost-free. Further, the substance of the product is also Shari'a based since the customer is provided incentives to save and preserve wealth, which is considered an objective of the Shari'a.

## Appendix

### A1. The Islamic Credit Card Controversy (Asharq al-awsat)

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<http://www.aawsat.com/english/news.asp?section=3&id=13869>

Riyadh, Asharq Al-Awsat - In recent years, the competition between Islamic banks has increased over offering Shariah-compliant credit cards – once a controversial subject among Islamic jurists. However, the prevalence and popularity of Islamic credit cards is also accompanied by customer complaints about the expensive costs charged by some Islamic banks that offer them. In fact; such credit cards have become even more expensive than the ones offered by conventional banks.

Customers have reported that they were surprised to learn about the charge fees required to obtain the credit cards offered by some banks as ‘Shariah-compliant’ and which have been approved by the Shariah committees of the banks in question. Many of the complaints revolve around the fact that despite the cards being Shariah-compliant, they end up deceiving and exploiting customers in Saudi Arabian banks and those who prefer to undertake usury-free transactions.

Some people reported falling victim to bank advertisements after being lured in by the promise of advertising campaigns and the fact that the credit cards were Shariah-compliant only to realize that they would continue to pay the accumulated monthly charges for a long time. Add to that the issuance fees which banks deduct upon issuing cards to customers.

An Islamic banking researcher who agreed to speak on condition of anonymity stated that the credit cards currently offered by banks entail usury and even resort to interest in some transactions. He added that this practice sometimes meant that charges exceed the interest rates employed by conventional banks for traditional credit cards.

The expert and researcher also added that banks practice a concept known as ‘Tawaruq’\* and sell commodities in global markets on behalf of the customer, receive payment for them and pay the accrued interest on cards – provided that customers continue to pay the remaining installments on the card.\* He also stressed that the Islamic Fiqh Academy (IFA) launched a sharp attack against the banks that had approved and endorsed these cards during its recent session held in Muscat.

The so-called interest received by Islamic banks or conventional banks that have Islamic banking divisions or branches comes through charging 60-100 Saudi Riyals (SAR) (US

\$16-26) or more according to the card type, aside from the annual fees – which means that the banks receive that ‘interest’ whether the customer uses the card or not.

According to the expert, the credit cards that are indeed Shariah-compliant are limited. An example is the ‘charge card’ on which the issuing bank grants the cardholder a loan with within certain limits – depending on whether it’s a gold or silver card etc. – for a certain amount of time. However, the amount must be paid in full at the agreed upon time and in the case of overdue payments, no usury-related payments are charged. Usually the term of installment payments is between 45-54 days after which the payment is taken in full from the account.

Another expert in Islamic banking also agrees; he said that some Islamic banks offer credit card policies that are misleading and that resort to usury in their practices and that it causes great injustice to the customers and does not comply with Islamic religious provisions.

The expert, who specializes in Islamic law and transactional jurisprudence, believes that the burden of the responsibility belongs to the banks’ Shariah committees that encourage banks to offer such products which are unanimously prohibited by the majority of contemporary Muslim scholars. He added that most banks offering credit cards do so with the objective of acquiring interest – which is strictly and unequivocally prohibited by Islam.

The expert went on to warn people against falling into the trap of the so-called Shariah-compliant cards which launch effective advertising campaigns around this time of the year. Moreover, he stressed that the only Shariah-compliant credit cards are the charge cards which only a limited number of banks offer.

Meanwhile, the Shariah committees in banks have issued their defenses in the face of the accusations leveled against them and the debate is still ongoing. The expert also explained that credit cards represent a guarantee by the bank to the customer, particularly in places such as hotels which rely more on credit cards than they do on cash.

However, the Shariah committees believe that the administrative fees charged by banks are their right since they need to make a profit and thus do so without resorting to usury like conventional banks – but he agrees that most of the local banks [in Saudi Arabia] charge exorbitant fees.

Some believe that there is no such thing as non Shariah-compliant cards and uphold that customers have a choice to either accept the terms and authorize the bank to sell commodities through Tawaruk on their behalf, also paying the credit card’s interest through that, or not.

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Today, the advertising campaigns of many banks can be seen throughout the cities with the advent of the summer holidays and they particularly target women. These campaigns employ terminology and tactics and are devised in a manner that is both suggestive and convincing to lure potential customers into thinking that these credit cards are Shariah-compliant, and easy to possess and repay.

\* Tawarruq: Shariah-compliant of finance through which loan finance is raised by buying installments in local commodities that are owned by the bank.

\* Credit cards within the Islamic banking framework are linked to personal lines of credit to ensure that users only 'borrow' money from themselves and not the issuing bank. The banks, in turn, make money by charging fees.