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Assessing the Impact of Islamic Banking and Finance

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INTRODUCTION

It is more than a quarter century now when the practice of Islamic banking and finance began in earnest. The Dubai Islamic Bank, a private company, as well as the Islamic Development Bank, a symbol of the Muslim peoples' endorsement of the idea launched by the Organization of the Islamic Conference (OIC), were both established in 1975. The idea is maturing, the numbers are growing, and the market share is increasing. There must be something that sustains it in an environment overwhelmingly dominated by conventional finance.

The first attempts to establish Islamic Banking Institutions, IBIs, were made in Egypt (Zaman and Movassaghi 2001). IBIs now operate in 75 countries with combined assets of around \$200 billion (Dudley 2001). Some of the IBIs operate in countries where no other financial institutions are allowed to operate. These countries are Iran, Pakistan, and Sudan. In the other countries (i.e., the remaining 50 Muslim countries that are members of the Islamic Development Bank, IDB.), these institutions represent only a small segment of the total banking sector. Even in the Arab world where the demand for the services of IBIs is the strongest, only 20 percent of the populace currently participates in the use of these facilities (Ibid.).

The question arises why despite a trend towards a more conservative approach to Islam, the IBIs have not attracted the majority of the population of the Muslim countries. The answer is to be found in the nature and the practices of these institutions, which are viewed either as questionable from the Islamic point of

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view, or misleading and untrustworthy. To date, there are no set standards or practices, or proper regulations of the IBIs. The individual religious councils (*shariah councils*) devise their own set of guidelines for operations that are not consistent from IBI to IBI or from one country to another. The collapse of the Dubai Islamic Bank in 1998 for multi-million dollar fraud did not help the image of IBIs at all (Ibid.). The memory of the collapse of the Ar-Ryan investment bank in Egypt a few years earlier, also because of fraud, was not dissipated yet when this came to light.

For the IBIs to become the principal financial institutions in the Muslim countries, some fundamental changes have to be made. The objective of this paper is not only to show that the IBIs, in their current form, have neither contributed to the healthy development of the domestic financial sector of the Muslim countries, nor have they made any significant impact on the overall economic performance of these nations, but also to point out that these financial institutions do not serve the economic interests of all the people, even in countries where such institutions are the only ones allowed to operate, and, as such will remain in the periphery of economic activities. The study concludes with some suggestions for reforms in the basic tenets of the IBIs that ought to transform them into truly Islamic, but efficient financial entities.

VIEWS OF THE ISLAMIC BANKS

It has not been possible for this writer to get the documents stating the views of the central banks and the monetary authorities in the OIC countries. There is no doubt, however, about the position they take.

As regards Islamic banks, it appears that they were led to believe that their activities do not result in money creation or monetary expansion. The most they admitted was that acceptance of demand deposits by Islamic banks justified central bank supervision to the *extent of these deposits only*, out of which a fractional reserve could be required by the central bank.

The implication was clear: accepting deposits into investment accounts and investing the funds so mobilized did not call for central bank regulations or fractional reserve requirement. Indeed, some writers did make the erroneous claim that the activities of the Islamic banks would not result in money creation.

The Literature on Islamic Banking

Let us now turn to the literature on Islamic banking and see what positions were taken on this issue which became a subject of discussion, in the early eighties, between the central banks and the Islamic banks.

Early Arabic literature on the subject has mostly discussed how a financial institution could work without interest adopting the contracts mentioned in Islamic *fiqh* like *mudarabah*, *shirkah*, etc. With the exception of the Egyptian study (Cairo 1972), it did not address itself to the larger question of how the entire financial system of a country could be organized free of interest and working according to *shari'ah*. It does not mention central banking and does not discuss the relationship between the individual Islamic banks and the central bank of the country. This is quite understandable in view of the political realities and the actual possibilities in the Arab world at that time.

In contrast, the literature on Islamic banking originating in the Indian sub-continent generally addressed itself to the latter issue: banking without interest at the national level. The emergence of Pakistan with the promise of establishing an Islamic state and the possibility of introducing there a financial system free of *riba* had provided a realistic need for such an approach. Hence the operational details of Islamic banking were worked out in the framework of a country's financial system as a whole and central banking as well as the relationship between individual banks and the central bank also received some attention (Siddiqi, Mhd.Nejatullah, 1988). This literature recognizes the fact that financial intermediation through Islamic banks would result in money creation and monetary expansion and that there is a need for central bank regulations to control money supply as well as to ensure liquidity and solvency of the system. However, there is some difference of opinion regarding the details.

As regards the demand deposits most of the writers recommend fractional reserves while some recommend 100 percent reserves (Siddiqi, Mhd.Nejatullah, 1988). Regarding investment accounts all writers agree that Islamic banks should keep some liquid reserves against these deposits so that withdrawals from these accounts could be made smoothly according to the terms and conditions under which investment accounts are accepted. There is, however, a difference of opinion

regarding the need for statutory reserve requirements against investment deposits.

Chapra argues that "the *mudarabah* deposits are treated in the Islamic system like bank equity and, since there is no statutory reserve requirement against other forms of equity, there is no reason why *mudarabah* deposits should be subject to reserve requirements."(Chapra, M. Umer, 1985) Mohsin Khan also recommends the same: "No official reserve requirements would be necessary for these investment deposits, although presumably for prudential reasons banks would maintain some minimum level reserves"(Khan, S. Mohsin, 1987). Earlier, Siddiqi had argued "It is advisable that the bank should keep a fixed percentage of *mudarabah* accounts as reserve, so that normal return of money to the depositors need not depend on the return of bank capital from business concerns"(Siddiqi Mhd. Nejatullah, 1983). Most writers on the subject seem to be in favour of statutory reserve against all bank deposits, (Ariff, Mohammad, 1987) even though the ratio of reserves against *mudarabah* accounts should be very small.

ATTRACTIVE FEATURES OF THE ISLAMIC APPROACH

Islamic resurgence in the twentieth century assumed proportions nobody could afford to ignore. Whether one leaned towards a possible clash of civilizations or hoped that interfaith dialogue would help usher in a happy age of coexistence in the global village, Islam was there as a major factor on the world scene. And the Islamic financial movement happens to be one of the unique features of twentieth century Islam. The fact that its rise coincided with the Muslim countries' coming out of colonial rule speaks volumes about its place in the Muslim psyche. It is as much an expression of their distinct identity as any other symbol of independence, but there is a distinction no other symbol shares with it: It is meant for all. As Islam permeates deeper in contemporary Muslim societies, by accommodating what is new but useful and shedding what accompanied it for long but was not essential, the significance of an Islamic approach to such a mundane affair as finance dawns on all concerned. After all it was a moral approach to mundane affairs that was the essence of the Prophet's mission. Anyone who takes Islam seriously can

hardly ignore the moral approach to money, banking and finance represented by this new phenomenon. That makes every Muslim a stakeholder in this venture. The same feature makes outsiders give a greater weight to the enterprise than its current size or volume would call for.

A return to ethics and morality is on the cards. Disillusionment with an amoral approach to economics and exasperation at the excesses of secular-materialistic-hegemonic policies of politicians has created a new environment. The ‘end of history’ triumphalist phase is over. People, including the intellectuals, are willing to listen. Is a moral approach to economic activity possible? Is it possible to define distributive justice in terms which take into account not only the immediate and the actual, which is often affected by things transient and insignificant, but also in terms of things essential and durable which relate to the core of the human situation? Is it desirable to manage money, banking and finance in total indifference to such problems as poverty, unemployment and increasing levels of anxiety? The fact that the Islamic financial movement claims to be based not on a fine stroke of human ingenuity but on divine guidance and prophetic insights makes it disarmingly simple. Alone in an age marked by its scepticism and uncertainties, the Islamic financial movement commits itself to a sacred text. To do so in matters economic leaves many gasping for their breath. But the fact that the text is not the handiwork of victors in a war or champions of a particular class, the fact that it is supra-human, introduces an attraction no other school of thought can muster. For, whatever the difficulties faced in drawing guidance from a text revealed in the seventh century for life in the twenty first century, it could not possibly be seen promoting the interest of one group of people at the cost of the interest of others. The universal nature of the teachings of Islam relevant for finance, be it prohibition of *Riba* (interest) and *Maysir* (gambling) or the obligatory share of the poor in the wealth of the rich (*Zakat*), could hardly be doubted.

But did the movement really demonstrate in practice its ability to fulfil the promise of a moral handling of money, banking and finance that it bears by virtue of its being rooted in religion? That, of course is a different question, one which needs some research before it can be answered. The point I wish to make at this stage is, the very promise raises hopes no other approach has

been able to raise.

An Assessment of the Nature of IBIs

To the advocates of Islamic banking, IBIs are revolutionary and their speed of growth is “unprecedented in modern financial history.”(Siddiqi 1999, p.33). To quote Siddiqi further, “In Western banking, earnings/returns to shareholders is the sole criterion of success. Islamic banks, however, seek to maintain a greater balance between the interests of investors, shareholders, users and society.”(Ibid.). To the critics, this assertion is at best misleading, but in reality rather deceptive (Zaman and Movassaghi, op. cit). The reasons are the following.

The *raison de tar* of Islamic banking is the avoidance of dealings with interest. This is because the proponents of the IBIs insist that interest and usury are one and the same. This author has elaborated elsewhere (Zaman and Movassaghi 2002, Ch.14) that one should not equate all interests with usury because the Islamic jurisprudence (*Shariah*) does not provide any such injunction, contrary to the opinions of those who swear by their convictions. One can prove that if indeed all interests are usury, then today’s IBIs cannot justify their existence. Some of the instruments dealing with the trade-related and investment type financing are actually based on interest rates, cleverly concealed as profit/loss sharing. Especially, the *murabaha* transactions often set mark-ups that would be considered usurious by Western banking standards. Since the mark-ups are fixed, they are usually for the benefit of the bank and its owners. Siddiqi needs to show how this type of transaction is for the benefit of all the parties he listed above. Even the Pakistani Council of Islamic Ideology, in their assessment of the *murabaha* transactions there admits that the “transactions practically the same as an interest-based transaction with ‘mark up’ becoming a part of the business lexicon of ‘interest rate’.”(IIE1997, Ch2, p.28).

The IBIs are essentially finance companies, specializing in the financing of consumer goods (*murabaha*) with very little, if any financing of accounts receivables or inventory financing for businesses. The lease/purchase financing (*ijarah Muntahia Bittamleek*) appears to be the second most important instrument, after *murabaha*, for them. Over 55 percent of the assets of IBIs in 2000 were in these two categories (Islamic Development Bank Annual Report, 2000 Appendix 1). Another 36 percent of the

assets are invested in Unit Investment Fund of the Islamic Development Bank, IDB, (Ibid.). From the financial statements of the IBIs, presented by the IDB in its Annual Report it is apparent that the IBIs are engaged in specialized operations that can yield for them high returns with very little risk to them. These financial reports do not indicate much of any traditional commercial banking operations. It is no wonder that most of the people who use the services of the IBIs also deal with conventional commercial banks (Naser, Jamal, and Al-Khatib 1999).

Unlike the conventional commercial banks that are subject to regulations by the central banks and /or other governmental or official bodies, the IBIs are not subject to such supervision and, as such, are not accountable to public scrutiny. The result is that there are no uniform standards by which their operations are assessed. The *Shariah Council* of each institution reviews the contract agreements to decide about their acceptability on religious grounds. Since there is no unanimity as to what is really permissible, confusion abounds. The banking practices are still evolving (Hughes and MacDonald 2002, p.68). It is very clear that the *Shariah Councils* only care to declare the financial instruments that bear ‘interest rate’ as un-Islamic without trying to understand what interest rates in modern financial transactions actually are. The result is that they routinely approve transactions that are usurious as long as it is in the guise of ‘mark-up’ or ‘profit/loss sharing.’ Any one who wants to point this out becomes a renegade, or worse, in the eyes of the proponents of IBIs. It is interesting to note that the Pakistan’s Supreme Court’s *Shariah* Appellate bench recently declared that not all forms of *Riba* (read usury) are prohibited (June 17th decision of the Pakistan’s Supreme Court via e-mail). Unfortunately, the Court is still calling interest as usury! Apparently, the Islamic authorities in Egypt have ruled that some interest rate charges are acceptable under Islam (Dudley, op.cit.).

The introduction of the so-called Islamic equity repurchase agreements, repo, further complicates the picture since it indirectly creates interest charges. “Interestingly, the growth of repurchase agreements in the US beginning in the 1950s came about because US banks were not allowed to pay interest on demand deposits. Through repurchase agreements, characterized as securities transactions, banks and non-banks were able

effectively to create with each other the short-term interest-bearing deposits prohibited by the regulations.”(Brooks1999).

The practices of the Islamic bankers are transparent to all but the devotees of the system. Increasingly, more and more people are raising serious questions about the financial instruments the IBIs use. “In fact, the great majority of Islamic transactions are not based on profit-sharing at all but on *murabaha*—another structure that bears a suspicious resemblance to an interest-bearing loan. In a *murabaha* contract, the provider of capital buys, say, a piece of machinery for \$1,000, and the borrower buys it back from the bank later for \$1,100. According to the *murabaha* rules, the \$100 represents a “mark-up”, but it works much the same as interest in everything but name (The Economist 2001, pp.76-77). Another Westerner who clearly sees through the façade states, “...the most common activities are no different to those undertaken by many conventional banks.” (Scott 2002).

ECONOMIC IMPACT OF THE IBIS

According to the Annual Report, 2000 of the IDB there are 53 countries that are its members. These countries from Afghanistan to Yemen Republic that include the oil rich Middle Eastern countries, generate only 6.6% of the total world exports (average of 1996-1998) or about \$360 billion. However, the intra-member exports average only \$36 billion, representing only 10.1% of their total world export. Even with their common bond of religion and membership to the IDB, neither the IBIs, nor the countries themselves made much headway in economic growth and prosperity.

The IDB Report shows that it had a total net income of Islamic Dinar, ID, 72.2million (i.e. \$97.3million @ \$1.347/ID) in 2000, of which ID26.3 million (i.e., \$35 million), or 36.4% of the total came from the *murabaha* financing discussed earlier.

The financial statements confirm that the IBIs deal with very few financial assets that conventional commercial banks operate with. Their limited scope of operation is a hindrance to the growth of healthy financial institutions that the Muslim countries need to compete in the global economy. As mentioned earlier the IBIs are essentially finance companies and are deeply involved in interest bearing assets. In order for these institutions

to contribute to the economic well being of the general public, it is high time that the Islamic slogan be abandoned to stop deception, and to generate trust.

NEED FOR REFORMING THE IBIS

The most important needed reform is to bring the IBIs under the supervision and control of the central bank of each country so as to ensure the pursuit of high standards of operation. The *Shariah councils* should be disbanded since these bodies allow usurious transactions, which they are supposed to prevent. Apart from the central bank, a nationwide bank examination body consisting of bankers, accountants, legal experts and government representatives, needs to be constituted to facilitate regular bank audits. The results of the audit must be published and widely circulated for the benefit of depositors, investors, bank customers, share- holders, and the interested public. Until full disclosures are instituted there remains the possibility of fraud and eventual bank failures.

The *Murabaha, Musharika, Ijara Muntahia Bittamleek, Mudaraba* transactions should all be stated in terms of actual interest rates charged, and these rates must be variable reflecting the current market conditions. Interest rates cannot remain fixed beyond the shortest possible time that it takes to figure out costs and returns. This is the only way one can fulfill the Islamic precepts of fairness and justice.

Under the existing banking practices of the IBIs, the bank officials (for example, in *Mudaraba* transactions) are not accountable for the failure of the transactions. The investors take most of the losses. Since the investors are mostly the depositors, it is they who lose their deposit money. There is no fiduciary responsibility for the bank officials. This must change since under the Quranic injunction the lender (read, depositors) is entitled to receive their principal amount lent (“*lakum ru’usu amwalikum*”, i.e., “you are entitled to your principal.”). The bank officials should be prosecuted for negligence and for will full disregard of duty.

Along with a closer supervision of the IBIs by the central banks and bank examining bodies as discussed above, the Muslim countries need to set up appropriate insurance institutions to insure part of the depositors’ money and to compensate for a part

of the losses from bad debts that crop up despite due diligence observed by bank officials. The premiums for such insurance should be funded by all users of the banking services as proportionate to their deposits or loans or investments in the bank. Modern financial institutions cannot perform adequate services without the assistance of insurance facilities.

In order to encourage the IBIs to perform basic commercial banking services, some limits need to be put how they allocate investment funds and assets. Clearly, the need for short term financing of business is paramount for the growth of the economy. The IBIs must develop short-term investment instruments similar to the modern banks with the proviso that all earnings should be variable reflecting the current economic conditions. At present some of the IBIs are placing deposits with Western banks to earn short-term returns, while others are resorting to futures markets!

For any institution, financial or other, to function effectively and above board there is the need for free flow of information. Most of the member countries of the IDB suffer from the absence of freedom of information and, as such, indirectly help to create an atmosphere of lack of accountability and transparency. The world community ranks them quite high in the list of corrupt nations. This does not help to attract badly needed investments for economic modernization and growth.

Much of this restructuring can be accomplished in the private corporate sector. To the best of our knowledge some of it is already under way in the form of new subsidiaries and syndicates. But it can take the Islamic financial movement a long way ahead if the state in Muslim countries shows awareness of the Islamic approach to economic life in general and to money, banking and finance in particular. The moral approach to worldly wealth, to what Alfred Marshall called the ordinary business of life, is not unique to Islam. All religions are supposed to share it. Even in the so called materialist western society the common man cannot possibly be amoral, not to say immoral. The problem lies with economics as a scientific discipline which refuses to admit ethics and morality. It is not possible to elaborate on this point in this paper. It is noted here to underline the need for Islamic economics in an Islamic society which wants to Islamize its financial markets. The major failure of capitalism noted above, that it promoted inequality between nations and within nations, cannot be remedied merely by introducing Islamic finance. It

requires behavioral changes on part of all economic agents, the individual consumer and producer as well as the state.

The suitability of the Islamic finance for the global village and its superiority over conventional finance does not lie in the opportunities it might offer for the moneyed people to make more money through investment. Rather it lies in its promise to ensure that good returns to investments shall be accompanied by promotion of the good of the society as a whole. A combination of efficiency with morally better end results requires that institutional changes be accompanied by moral regeneration.

CONCLUSION

In this author does not believe that any persuasion is needed because of the ways the IBIs ensure locked-in “profits” for the bankers and the investors at the detriment of the depositors and borrowers. It is doubtful that non-Muslims, and often the Muslims themselves, will understand that IBIs are not really following Islamic commands for justice and fair play, and that usury and interest are not always synonymous the way the proponents of the IBIs claim them to be.

In order for the IBIs to serve the Muslims as well as non-Muslims in an efficient manner in accordance with the Islamic precepts of justice and fair play, it is imperative that the IBIs be brought under the supervision of regulatory bodies and governed by some clear cut standards that were suggested above.

The multi-national financial institutions do not work to promote any kind of ideology or even the cause of their home countries. They are in the business to make as much profit as possible and as quickly as possible for them. The fact that the Citibank or similar institutions find IBIs attractive to them, and are opening up Islamic banking subsidiaries, should be of concern to all those who want to project the true spirit of Islamic precepts.

The future of IBIs look rosy to their proponents, but to the Muslims in general they appear to be institutions that are neither serving the cause of banking and finance, nor that of Islam. The Muslim countries need institutions that serve all banking and financial needs in an equitable manner, and the IBIs in their present mode of operations, do not fill that void.

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