ISLAMIC BANKING AND DEVELOPMENT: AN ALTERNATIVE BANKING CONCEPT?

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I. INTRODUCTION

Religions, more often than not, and to varying degrees, interfere with the economic behavior of men and women. The word “Religion” itself, and its Arabic counterpart “Dīn” and the essence of the message of all religions imply and indicate setting norms and standards for human behavior which, by definition, extend to the economic arena. Hence, it is not a surprise that religion relates to economics. Separation and divorce between them would be rather unusual.

The objective of this chapter is to give an overview of the developmental nature and characteristics of Islamic banking as a concept and how it is implemented by this relatively new generation of financial institutions called Islamic banks. This is essentially attributed to the nature of Islamic financing itself which is intrinsically inter-linked with transactions in the physical goods market and socially and morally committed. Therefore, to understand the developmental role of Islamic banking we shall first look at the foundations of Islamic financing. We will discuss what is meant by this term of Islamic finance? What are its guiding principles and how financial intermediation is approached through Islamic banks? Then we will take a quick look at the operations of Islamic banks in both fund mobilization and fund utilization. This will clear the way to the next section that will argue that Islamic banking has three major intrinsic characteristics that are developmental in their nature. These three characteristics are: a direct and un-detachable link to the real economy or physical transactions, integration of ethical and moral values in financing so that financing is directed to useful products only and the reconstruction of relationship with depositors on the basis of sharing instead of lending. The last section will discuss how would the Islamic model of banking serve as an alternative banking system?

II. FOUNDATIONS OF ISLAMIC FINANCING

What is Islamic financing?

The basic principles of Islamic banking are derived from the axioms of justice and harmony with reality on one hand and the human nature on the other hand. The most genuine and plain definition of financing, in general, is that it is the provision of factors of production, means of payments and even goods and services without requiring an immediate counterpart to be paid by the receiver. For instance, a laborer finances the employer by waiting until the end of month for getting compensation for the working hours given throughout the month, a physical capital owner finances the entrepreneur by waiting until the sale of production to get the rent of her machine, also a shopkeeper finance her customers by waiting until their pay day on the payments of consumer goods they purchased during the week and a bank finances its customer when it provides money for them to use in their buying of goods and services.

Islamic financing is no more than that, in its full, plain and direct sense. Islamic financing is a name for providing factors of production, goods and services for which payment is deferred. So simple and so straightforward! Real-life exchange and production processes have, as part of their components or forms, the provision of goods to consumers as well as machines and equipment, materials and other input-goods used in production to producers. The essence of Islamic banking practices is the provision of such goods and services while payments for them are delayed to later dates. Islamic banking also provides means of payments in the form of producers' principal in projects on the basis of sharing the actual, real-life outcome of a production process.

The guiding principle in Islamic financing

The principle of justice is essential in all forms of Islamic financing. In profit sharing, when al Islamic bank provides means of payment to the producers, both parties share the real actual results or net profit/loss of a productive project. It is not just to throw the risk burden on one side, the entrepreneur, by guaranteeing a given return to the provider of money regardless of whether the project makes money or looses money. The fair play of market forces determines the rates of distribution of profit of the operation among the financier and beneficiary.

When financing is done on the basis of sale or lease principles, the Islamic bank carries the kind of risk associated with buying and owning a good and then providing it to its user. In both the cases, the fair play of market forces determines the profit/rent of the goods provided by the financier to the beneficiary.

Since the Islamic law assigns to private property a corner-stone role, the owner should have a full right to the increase, growth, benefit and profit that is attributed to one's property. By the same token the owner carries the liability of any loss or destruction that may happen to its property. This is not only fair and consistent with human nature but it is the only rational thing to be done.

If a property is entrusted, by its owner, to someone else (through financing), the user's efforts that contribute to growth and profit creating must also be recognized. That is also humanly natural and the rational thing that should be done. The principle of justice and fairness requires that the result or actual outcome or profit of such cooperation should fairly be distributed between the two parties and nothing else. In other words, any distribution that is based on giving either party a pre-determined fixed amount regardless of the actual profit may not be fair or just.

On the other hand, in interest-based lending, instead of entrusting a productive property to an entrepreneur the lender gives money or real goods (be it life-time savings or any other loanable goods/funds) to the borrower against a notional right, that we call **debt**. Hence, lending changed the nature of what is owned from real balances that have claims on goods and services in the society to a legal commitment, which is purely an inter-personal abstract concept. A debt is, by definition and by its nature, incapable of growing or increasing because it is purely conceptual; it is a relationship between a person and another person. How can a debt grow? How can it increase? Except by arbitration, artificialities and pure contrivance!

In contrast, the same savings and/or real goods may be given on sharing bases. The owner holds on to the right of ownership and the user exerts efforts for making the goods grow and increase, like a peasant who buries seeds in the soil and serves them, or like a trader who buys merchandise and finds a good market for it. Ownership remains in the hands of the finance provider and the work is applied by the finance receiver. Both contributions are recognized as they participate in creating an increment, increase or growth. Therefore, both parties deserve to share the real outcome of that exercise.

If one wants one's financing to be guaranteed, why one then should have a claim on a part of the output of a project while bearing no part of its pain and risks. Fairness and justice require that losses should be carried in proportion to financing advanced. If a financier wants to have a claim on a part of the return of a project, then she/he must also carry a proportional share of the risks and burdens of the same. This is what we call the rule of "gains should always be linked to risk exposure".

Finance on the basis of profit/loss sharing opens the way to *direct investment*, where the utmost attention of the Islamic bank is directed to the profitability of investment. In this case, close working relations between the bank and the fund user (project manager) is required to monitor performance and to solve unexpected problems. As long as returns are commensurate with risk, direct investment would not shy away from high-risk projects, or from financing small and micro-enterprises.

In contrast, direct investment does not seem to be favored by conventional banks. Quoting an article in the World Bank Research Observer,[*]

> *"In the absence of full information, banks tend to allocate credit to firms with reliable track records or available internal funds, even if other firms present better investment opportunities. . . They are generally also reluctant to finance small firms that lack adequate collateral, even though such firms may be more innovative and promising than others."*

Financial intermediation in Islamic banking

Financial intermediation is the major function of the modern banking system; it is and probably the raison d'être of banks. Financial intermediation means taking funds from

[*] Dimitri Vittas and Yoon Je Cho, "Credit Policies: Lessons from Japan and Korea," World Bank Research Observer, Vol.II, No.2 (August, 1996), pp. 277-98.

person who have more than they need and providing them to persons who need them for their economic transactions and activities. This is done in conventional banks on the basis of loan contracts. Banks borrow funds from those who have extra ad lend them to those who need them for use in their production projects or in buying consumable goods and services.

Islamic banks are also financial intermediaries. They collect savings from income earners who have surplus and distribute them to entrepreneurs and consumers who need them to finance their purchases of goods and services. But Islamic banks make their financial intermediation on the basis of several contracts that do not include lending and borrowing because interest in prohibited in the Islamic law. Instead of the loan contract, Islamic banks rely on a combination of three principles: sharing, leasing and sale. What is essential in their function of financial intermediation is that Islamic banks leave the initiative of investment and use of funds to the entrepreneurs and other users of funds. In other words, while the provision of funds in Islamic financing is channeled through sale, sharing and lease contracts, the decision making of getting goods that are purchased for sale or lease and of establishing projects is left to the users of funds and the Islamic bank acts upon orders from the users of funds as we will see in the next section.

III. OPERATIONS OF ISLAMIC BANKS

Contemporary Islamic banks have been founded on the banking model that existed in Europe and North America, with regard to their main layout, departmental structure and their basic functions of mobilizing financial resources and using them to finance those who are in need for investible funds. Obviously, the difference lies in the area of modes of financing that are, in the case of Islamic banks, derived from the Islamic system and structured within the Islamic legal framework.

1. Fund Mobilization

Resources are mobilized from shareholders and savings owners. Shareholders own the bank's net equities while savers participate in the ownership of the bank's investments. In other words, savings are mobilized on the basis of sharing rather than interest-based lending, of course, except for demand deposits that are loan-based and guaranteed by the bank. In Islamic banks, there are two kinds of depositors: those who are investors or in a sense a special category of shareholders and those who want their money intact and guaranteed by the bank.

2. Fund Utilization

Islamic banks use available funds by means of three major categories of financing modes: **sharing modes, sale modes** and **leasing modes**. None of them has any interest component.

The principle of sharing modes is simple as much as it is natural. The Islamic banks provide financing to projects on the expectation of a share in the return. Obviously, if a project loses, all capital providers and financing contributors lose together and proportionately. There are two forms of applications of this principle: **full partnership financing** and **non-voting partnership financing**.

The idea of sale modes of financing is also simple. The bank would be asked to buy goods and give them to users (producers and/or consumers) against future repayment. Sale modes may take several forms. The simplest of them is derived from regular sale contract where the bank sells real goods, equipment and machinery to their users at an agreed upon marked-up price. Two other forms of sale-based placement of funds are also practiced by Islamic banks: **construction/manufacturing contract** and **deferred delivery contract**. Sale based modes can end up in one lump sum deferred payment or in installments spread throughout a certain period of time.

Finally, as practiced in leasing companies and recently in many conventional banks, leasing modes can have a variety of forms with fixed or variable rents, declining or fixed ownership, operational or financial, along with different conditions regarding the status of leased assets at the end of the lease period.

IV. DEVELOPMENTAL CHARACTERISTICS OF ISLAMIC MODES OF FINANCING

The essential characteristic of Islamic modes of financing is their **direct and un-detachable link to the real economy or physical transactions**. Sharing modes are only possible for productive enterprises that involve real-life businesses that increase quantity or improve quality or enhance usability of real goods and services; and by doing that, such businesses generate a return that can be distributed between the entrepreneur and the financier.

Sale-based modes are those that involve actual, physical exchange of commodities or provision of services from one hand to another whereby financing is measured only by the real sale of commodities and can only be provided to the extent of the real value of goods exchanged. The same thing also applies to leasing where leased assets are the pivotal thing around which financing is built.

In other words, Islamic financing is purely a **real-life, real-goods/services financing**. No financing can find its way to the Islamic system without passing through the production and/or exchange of real goods and services.

In contrast with conventional finance methods, Islamic financing is not centered only on credit worthiness and ability to repay loans and their return. The key word in Islamic financing is the worthiness and profitability of a project and the exchange of goods, merchandise and services. On the other hand, the ability to recover the financing principal becomes a by-product of profitability and worthiness of the project itself. It is or course a necessary condition in Islamic financing but it is not sufficient.

Consequently, the nature of Islamic financing makes it exclusively restricted to the construction, establishment and expansion of productive projects and to the exchange and trade of commodities and services. In other words, Islamic financing is intrinsically integrated with the goods and commodities market and is limited to the needed amount of finance that is required by actual transactions that take place in the real market.

Whether it is done by means of sharing, sale or lease contracts, Islamic financing is bound by the extent of transactions in the real goods and services market. The Islamic modes of financing, by virtue of their very nature, are incompatible and unsuitable for debt rescheduling, debt swap, financing of speculative cash balances, inter-bank liquidity, speculative transfers and other purely monetary/financial activities that make a substantial part of contemporary activities of conventional banks. This is, in fact the **first and foremost characteristic** of the Islamic approach to financing.

Additionally, the **second characteristic of Islamic banking is the integration of ethical and moral values** with Islamic finance and banking complements the developmental role of Islamic banks. Islamic banks cannot detach themselves from ethical/moral considerations even if they try, especially, that their own environment, including both staff and clientele, expects from them a pattern of actual behavior that is consistent with their commitment to moral and ethical standards as laid down by the Islamic religion and always measures them to those values and standards on whose grounds Islamic banks establish their raison d'être.

The immediate and most important outcome of the moral and ethical commitment of Islamic banks is developmental in nature. Islamic banks restrict their financing to goods and services that are useful and abstain from financing harmful goods such as alcoholic beverages and tobacco or morally unacceptable services such as casinos and pornographies regardless of whether or not such goods and services are legal or not in a given country. Thus unlike conventional banks that take the credit worthiness and rate of interest as standards in judging their provision of financing, the Islamic banks have to apply the Islamic moral/ethical criteria in screening their financing; they do not extend their help to activities that are, in the final analysis, harmful to the society and consequently anti-developmental even when such activities are permissible by the law of the land. This adds another dimension to the developmental role of Islamic banks that has a long term effect on the productivity in the economy as it reduces the social and economic cost of such harmful products and activities.

There are other forms in which the ethical/moral commitment of Islamic banks is manifested. For instance, many Islamic banks have established a practice of providing goodly (interest-free) loans to their clientele in cases of dire needs, overdrafts or unexpected circumstances.

Many Islamic banks also establish social funds especially designed for relieving economic hardship of the poor and needy. These funds are usually financed by the yearly Zakah dues on shareholders' equities as well as many investment depositors who give their consent to the bank's management for the deduction and distribution of Zakah annually. These charitable activities of Islamic banks are also financed by Interest money that may accrue to the bank from its deposits in conventional banks and from certain transactions that the Shari'ah boards may find doubtful/suspicious from a Shari'ah point of view. This is on the ground that such earned interest can't be taken by the bank and must be distributed to charity. Charitable funds of Islamic banks are usually also open to receiving donations from the public.

In this regards, the experience of two Islamic banks may be quoted as examples. The Islamic development bank in Jeddah, Saudi Arabia that is an Islamic inter-governmental banks with 57 Muslim countries in its membership, and some two billion U S Dollar as paid-up capital in the mid 1990s,[1] accumulated about one billion U S Dollar in earned interest by the end of the last century and established the largest ever Islamic charitable endowment fund (Waqf) for charitable services throughout the Muslim countries and communities. This Waqf was established in 1999 with one billion U S Dollars as an initial endowment. This is in addition to some US Dollar … million spent of research, training, developmental study, research scholarships, technical assistance programs and disaster relief servicing the Muslim countries, peoples and communities in Muslim-minority countries between 1975 and the end of 2004.[2]

The Jordan Islamic Bank is the other example. It established a special fund for interest-free loans to needy persons. In the three years of 2001 through 2003, the fund provided USD 22 million to

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[1] The Paid up capital was increased to U S Dollar 4 then 6 billion in the late 1990s then to24 billion in early 21st century.

[2]

more than 40 thousand beneficiaries, an amount that is approximately 230% of the total net profits realized by the bank during these three years.[3]

When we look at financial reports and statements of individual Islamic banks we will find each of them having a list of contributions to community, environment and social welfare. Interestingly, the employee health insurance programs of most Islamic banks cover not only the immediate family members of the employee (spouse and children) but also parents and unmarried or divorced daughters without any age limit. Such practices are motivated by the Islamic concepts of extended family and financial responsibilities of the income earner for parents and all adult females in the family.

Additionally, since most Islamic banks operate within an interest-ridden environment and have working relationships with conventional banks, they often accumulate interest balances as a result of such deals and transactions. According to the Islamic Shari'ah, earned interest cannot be taken as income. It is rather considered unlawful for the earner and must be disposed of to the poor and needy in a way that does not directly benefit the Islamic bank. Hence, those Islamic banks that happen to earn interest spend it on benevolent social activities.

In other words, although profit maximization is equally essential to Islamic banks as other businesses, the underlying philosophy of these institutions is conducive toward social commitment and activities that usually cannot be interpreted by the profit motive.

The **third developmental characteristic of Islamic banks is found in the nature of their relationship with depositors**. While conventional banks receive current and timed deposits against fixed interest, Islamic banks deal with their depositors on investment grounds. They receive deposits on the basis of sharing in the result of the bank's activities. The application of sharing in fund mobilization makes the bank's performance the criteria of its ability to raise deposits which means that each bank will keep attempting to out-perform other banks if it wants to attract funds from investors. This out performance shall have a clear and strict

[3] The yearly financial reports of the Jordan Islamic Bank, 2001-2003.

measure that is expressed in the bank's profitability. The result will be that the management of the Islamic bank will have to appease not only the shareholders but also the depositors who both will be looking after profitability. Consequently, competition among banks drives the profitability to its maximum in both the short run that concerns depositors and the long run that concerns shareholders. This is in contrast with using advertisement and other decorative means to attract deposits.

Additionally, rendering the profitability criteria the measure of performance for depositors make them more aware and attached to the real market. This helps creating an entrepreneurial spirit in the depositors because it keeps them alert to profit making. This applies to their selection of the bank of choice and to profit making as means for earning in contrast of relying on fixed incomes that are provided by conventional banking. Furthermore, involving the masses of depositors is the profitability of banks brings them closer to the real market instead of keeping a firewall between those who save and those who invest. It also changes the nature of financial intermediation of the banking system bringing it to be in more harmony with real market and developmental changes in it. This can be manifested by noticing that in good times the banks will be able to distribute higher profits to depositors while they can lean on them in bad times by distributing lower profits instead of going to bankruptcy if they have to give depositors pre-fixed rates of interest.

We believe that in the small world of today and with prevailing cultural intermingling, having Islamic banking services available to every person, Muslim and non-Muslim alike, in all countries is a very important achievement to which we must all look forward, because the Islamic banking methodology provides customers with expanded options of banking services that they can choose from. The whole world community will certainly become better off by having Islamic financing available to all customers every where regardless of its religious tan. Moreover, Muslim communities in the West need to have Islamic banking institutions as they represent, for Muslims, an approach for development that is compatible with their faith and it is in this sense an essential element of their religious fulfillment. This will add to the developmental effort of all humanity and enhance the involvement of all in working together to make our world a better one.

V. ISLAMIC BANKING AS AN ALTERNATIVE APPROACH

One might wonder whether Islamic banking and finance is an alternative approach to conventional banking or may be the most modern generation of banking.

In an attempt to answer this question we have to notice that the banking business is no more than a possible means to satisfy the needs of society according to the prevailing conditions and circumstances. Those needs should always govern the means, not be their subject.

The most important function of modern banking is the art of mobilizing funds for investment. Islamic banking is a system that mobilizes savings on the basis of profit/loss sharing which we think is fairer and more conducive to investment and development although it is for Muslims a matter of faith.

The ultimate test of such an alternative is whether it is successful or not. It can be safely said that the idea of Islamic banking has been successful. It has been expanding at an annual rate of more than 11% for the last three decades. It is, therefore, not surprising to find several international banking institutions joining the rally by started by establishing their own Islamic units, windows, branches or full fledged Islamic banks to better serve their customers and capture the opportunity. Islamic banking has been partially practiced by several of the international giant banks and financial institutions in Switzerland, Britain and the United States.

Economists have argued that the wider is the freedom of choice the higher is the level of social welfare. A wider choice implies greater respect of human rights. When an alternative concept such as Islamic banking is introduced, a new choice is open to the market, with obvious economic and social benefits.

Introducing Islamic banking as a new choice has also further benefits related to the advantages it provides to many fund users.

Commodity and service producers would certainly appreciate equal opportunities for obtaining capital based on the merits of their businesses rather than on their personal creditworthiness alone. Those entrepreneurs who prefer to be self employed need ways to obtain financing other than borrowing. Islamic banking gives those pioneers such an opportunity on the basis of profit/loss sharing.

In general, Islamic banking/finance places more weight on the merits of the business to be financed than on the wealth of the fund user. As a result under this new banking alternative, a better distribution of credit may be achieved.

VI. A CONCLUDING NOTE

This Chapter must end with a note that the innovation of Islamic banking in re-structuring the financing relationships between the bank and it depositors on the one hand and the bank and funds users on the other hand is religion neutral in the sense that although it is on the Islamic outlook to finance and business, its application is not religion based. Hence, it fits and can be applied alongside any culture and religion.

However, one has to keep in mind that there may always be certain differentials between theory and practice. The basic shortcoming of today's Islamic banking come from two sources: inability of management and staff to cope with the principles and approaches of Islamic banking and negative effects of the interest-ridden financial environment within which Islamic banks operate. Both factors cause the actual practice to fall short of the ideals on which Islamic banks are established and to bring these institutions down to copy and imitate their interest-based counterpart. Only God knows where a compromise will land!

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