ISLAMIC BANKING AND FINANCE IN THE 1990's AND BEYOND : PROBLEMS AND PROSPECTS

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under my supervision. The relevant comments made on the paper during its presentation have been incorporated in the present version of the paper to my full satisfaction.

I have pleasure in recommending that the graduate committee may approve the paper in partial fulfilment of the requirements for the degree of Master of Economics.

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ISLAMIC BANKING AND FINANCE IN THE 1990's AND BEYOND: PROBLEMS AND PROSPECTS.

MUHAMMAD AMINU BAWA

A. INTRODUCTION

Islamic banking and finance has become a lasting phenomenon with many scholarly researches being conducted all over the Muslim and some non-Muslim countries. The first experiment in modern time took place in Mt. Ghamr a Delta area of Egypt in the 1960's. Since then, several Islamic banks have been established in many Muslim and some non-Muslim countries.

1. Statement of the Problem.

Over the years, the activities of Islamic banks have been found to be impressive. In view of the fast changing world of today and the potential role of Islamic banking and finance, this paper is of the view that there is alot of work to be done. Most of the Muslim countries belong to the category of the Less Developed Countries (LDCs) although some of them are very rich in terms of mineral resources and vast agricultural potentials. These countries are far from being developed. Many policies and programmes have been implemented to accelerate their economic development with little success. Thus, there is an urgent need for developing those economies now more than ever before. One major constraint is financing economic development. This is where the role of banking and finance comes in.

2. Objectives of the Study

This study is an attempt to chart new policies and strategies which are expected to enhance the potential role of Islamic financial institutions in the 1990's and beyond. The following objectives are pursued in the course of this study:

(i) To analyse the current status of Islamic financial institutions;

(ii) To discuss the current problems facing Islamic financial institutions;

(iii) To suggest ways for solving the problems identified; and

(iv) To highlight the future prospective role of Islamic financial institutions.

3. Anticipated Contribution.

This paper is expected to contribute to the field by reviewing and systematizing the existing literature in the discussion of Islamic banking and finance. The paper also seeks to offer some novel suggestions. For example, we are going to show how and why Islamic banks should diversify their investment portfolio to enable them to provide long term financing in a considerable magnitude.

4. Limitations of Study.

This study is constrained by lack of adequate empirical data to support some of the issues raised in the paper. The major sources of data are newspaper reports (which are not a serious material for scientific research purposes) and annual reports of Islamic banks and financial institutions. Thus, there appear to be gaps (wide in some cases) in the data where available. The study is therefore conducted within the limitations imposed by data availability.

The rest of the paper is organised as follows: Section B discusses the concept, objectives, and current status of Islamic banking; then section C highlights the current problems of Islamic banks and attempts to provide some suggestions for solving the problems. In section D, the paper addresses the future prosipective role of Islamic banks and section E concludes the paper.

B. CONCEPT, OBJECTIVES, AND CURRENT STATUS OF ISLAMIC BANKS

1. What is an Islamic Bank?

It is argued that an Islamic bank is not merely an interest free financial institution. It is also not just a development or investment bank nor is it just a profit sharing financial intermediary. Rather, an Islamic bank is seen as an institution with integrated features which embrace social, investment, and developmental issues. It must also be ideologically Islamic in its operations.[1] In other words, an Islamic bank has dual responsibilities: one is to the investors and the other to the Ummah in general.

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[1] Man, Z.,`Islamic Banking: Propects of Mudaraba and Musharaka Financing,' in Sadeq, A.H.M. et al (eds) Development and Finance in Islam, Kua la Lu mpur : International Islamic University, 1991, p.239.

2. Objectives of Islamic Banks

Manzoor (1986) argues that Islamic banks and financial institutions are established to achieve the following objectives:

(i) To prohibit the element of interest in financial transactions and instead introduce the concept of profit sharing, equity participation, hire purchase, etc,to pave the way for socialization of resources.

(ii) To carry out their activities in conformity with the Islamic welfare principles embodied in the Qur'an so as to establish a monetary and credit system based on justice and fair play.

(iii) To create necessary facilities for the expansion of public co-operatives through the attraction of funds, savings, deposits and accumulations, and to mobilize them for development; and

(iv) To preserve the value of money and create equilibrium in the balance of payments along with the provision of facilities in commercial exchange.[2]

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[2] Manzoor, N., Islamic Economics: A Welfare Approach. Karachi: Sa'ad Publications, 1986, pp. 59-60.

3. Current Status of the Islamic Banks[3]

In this section, two approaches are adopted to analyse the current status of Islamic banks. These are (i) Establishment of Islamic banks and (ii) Financial analysis. In the case of the former, it is instructive to note that in three countries: Pakistan, Iran and Sudan, financial institutions are expected to conduct business in accordance with the Shari'ah. In addition, there are more than fifteen other Muslim countries with Islamic financial institutions besides as well as 10 non-Muslim countries.

Appendix I shows that Sudan has the largest number of Islamic banks in any one Muslim country. There are six Islamic banks with their network of branches spread throughout the country. This is followed by Bahrain with 5 and 4 in Egypt. Appendix I also shows that in non-Muslim countries, there are two Islamic financial institutions in Switzerland and the United Kingdom. It is also obvious from Appendix I that 41 out of 59 (or about 70 percent) Islamic financial institutions were established in the decade of 1980's alone.

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[3] I owe the title of this sub section to Dr Ausaf Ahmad in his paper titled `Contemporary Experience of Islamic Banks: A Survey. Unpublished paper presented at the Seminar on Financial Institutions in Accordance with Shari'ah, Jakarta, September 17-19, 1990. However, the discussion is based on Appendices I and II presented at the end of the paper.

Appendix II presents financial analysis of some Islamic banks and financial institutions. Islamic banks can be ranked in terms of shareholders' equity. The Appendix shows that of the 23 Islamic financial institutions, the first on the list is Dar Al-Maal Al-Islami, Bahamas as of 1987. It is followed by Kuwait Finance House and Faisal Islamic Bank of Egypt. The Bangladesh Islamic Bank is at the bottom with US $3,310.

In terms of authorized and paid up capital, Appendix II shows that 5 out of the 23 Islamic financial institutions have already paid up the authorized capital. These institutions are Faisal Islamic Bank, Bahamas; Islamic International Bank, Denmark; The Kuwait Finance House; Faisal Finance Institution, Turkey; and the Dubai Islamic Bank. However, some banks have almost reached that status. For example, the Sudanese Islamic Bank paid up a total of US$19,365,000 out of US$20,000,000 as of 1986.

The Kuwait Finance House ranks number one in terms of assets. Its total assets as of 1987 reached about US$3 billion. In the case of total deposits, the Dubai Islamic Bank is leading while in terms of profits, the Kuwait Finance House occupies the first position with a total profit of over US$10 million.

. At this juncture, it is timely to comment that given these promising trends, Islamic banks and financial institutions have a bright future. If these institutions can diversify their investment activities to provide long term and rural development-oriented finance, they can change the structure of the economies of the Muslim World.

C. CURRENT PROBLEMS

1. Underdeveloped Financial Markets

The current status of financial markets in the Muslim countries can be presented as described by Wilson (1990) as follows "(i) In most Muslim countries, those markets are either non-existent or have developed to only a limited extent (ii) Government securities are traded to only a small extent and often carry interest, and (iii) Equity markets are also underdeveloped.[4]"

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[4]Wilson, R.,`Retail Success and Wholesale Possibilities' in Wilson, R. (ed) <u>Islamic Financial Markets</u>, London: Routlage, 1990, p.14.

In spite of this, the situation looks promising in some countries. For example, shares of specifically Islamic companies are quoted on the Amman, Cairo and Kuwait stock markets. Wilson (1990, p.14). Also the shares of Bank Islam Malaysia are now quoted on the main board of the Kuala Lumpur Stock Exchange (KLSE).

2. <u>Profitable Placement of Surplus liquid funds.</u>

The availability of surplus liquid funds occurs in the capital surplus areas in the Gulf region. Although these banks accumulate excess liquidity through customers' deposits and profit, they cannot avail themselves of the facilities of conventional money markets which operate on the basis of interest.

This arises principally because of the almost non-existence of inter-Islamic bank transactions and financial markets in the Muslim countries as observed in the preceding section. This hampers the ability of Islamic banks to place or raise funds among themselves on any established pattern. Even in Iran and Pakistan where such markets exist, they are confined to their respective local currencies.

To solve this problem, it is suggested that more Islamic banks should be established in other poor Muslim countries. If this is done, it is expected that a socially useful and economically productive outlets could be found for resources of Islamic banks located in capital rich countries. These Islamic banks can co-operate by undertaking joint ventures, co-financing development projects, operating accounts with each other and co-ordinanting their activities in a number of other ways.[5]

To achieve this, perhaps, it would be more preferrable to allow foreign Islamic banks to invest in hard currencies like the dollar or yen in various Muslim countries.

3. Dominance of Short Term Financing

Islamic banks provide medium and long term financing only to a limited extent. If an Islamic bank goes beyond the short term financing of working capital, the financing is provided not on the basis of Mudaraba or Musharaka but on hire purchase or leasing contracts. Perhaps the starting point in the

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[5] Ahmad, A., Development and Problems of Islamic Banks. Jeddah: International Research and Training Institute of the Islamic Development Bank, 1987, p.66.

investigation as to why Islamic banks concentrate more on short term financing is to argue that the shareholders and the bankers are in many cases conservative or at least cautious in the utilization of funds and the depositors prefer short term deposits. The available evidence suggests that <u>Murabahah</u> (which is a short term technique of financing) is dominant in most Islamic banks. See table below.

TABLE 1
Term Structure of Investment by Twenty Islamci Banks, 1988

Type of Investment	Amount	Percentage of Total
Short Term	4,909.8	68.4
Social Lending	64.2	0.9
Real Estate Investment	1,498.2	20.9
Medium and Long Term	707.7	9.8

Source: Ahmad, A., `Contemporary Experince of Islamic Banks: A Survey. Unpublished paper presented at the Seminar on Financial Institutions in Accordance with <u>Shari'ah,</u> Jakarta, September 17-19, 1990, p.35.

Table 1 above shows that as of 1988, the twenty Islamic banks represented above provided short term finance amounting to 68 percent of their financing. This is followed by real estate investment. Medium and long term lending was just 9.8 percent of the total financing provided.

In the case of the Islamic Development Bank, the first nine years of operation showed a heavy reliance on Murabahah financing which accounted for 78 percent of total financing. Similarly, in Pakistan, Murabahah was dominant. Data available show that as of June 30, 1984, 77.2 percent of total financing was on the basis of bay mu'ajjal (mark up). In Iran, Murabahah accounts for 55 per cent of total financing as of March, 1986 with profit sharing techniques accounted for 33 percent of total financing and 12 percent accounted for by Qard Hasanah loans.[6]

It is also reported that some Islamic banks indicate that they do not classify themselves as development banks but explicitly as commercial banks, not dealing with long term but with short term finance. According to these banks, in most countries, the state runs specialized banks to meet the financial need of the corporate sector for medium and long term financing.[7] At this juncture, a question arises as to whether Islamic banks should pursue the profit motive solely or not. This paper shall return to this issue later.

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[6] Ahmad, Z., `Islamic Banking at the Crossroads', in Sadeq, A.H.M., et al (eds), opcit., p.168.

[7] Nienhaus, V.,`The Performance of Islamic Banks: Trends and Cases', in Mallat, C., (ed) Islamic Law and Finance, London: Graham and Trotman, 1988, pp 158-159.

The current reliance on short term financing by Islamic banks is a product and a legacy of the initial stage of Islamic banking. At this stage, Islamic banks concentrated their operations on trade, real estate and constructions, etc. This is necessary because these are the types of projects which are short term in nature, bring the banks the principal amount, generate profit and give access to resources for further expansion. In addition to this, short term financing was also generally instrumental in bringing confidence among the managers and showing to the general public the overall feasibility and viability of Islamic banking.[8] But now the initial stage is over especially for the `old' Islamic banks. This calls for the need to come out of the short term finance, and diversify into medium term and long term financing.

Furthermore, Chawdhury (1986) exposes the danger of heavy reliance on short term finance. He argues that due to the shortage of risk capital and long term finances as well as exchange rate fluctuation, excess liquidity of the Islamic banks is not diverted to the hungry developing countries of the Muslim World, as a result of which they become easy prey for exploitation

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[8] Ahmad, A., op cit., p.64

by international financial agencies like the IMF and other clubs of international creditors. Because most of the investments in the industrial sector require long term finances, short term and trade finances cannot serve the purpose of total development.[9]

Islamic banks concentrate on short term financing perhaps because of some technical and operational problems associated with long term financing techniques like Mudaraba and Musharaka. Ariff (1991) has argued that Mudaraba is not easy to apply especially for an infant Islamic bank in view of the high risk element involved, especially since all capital loss is borne by the bank. On the other hand, Musharaka mode appears to be more practical and less risky, given that losses are shared by both the bank and the customer. But the problem with Musharaka is that most customers resent the idea of sharing ownership and control with a financier (e.g. the bank). In a society where Islamic banks co-exist with conventional banks, there is a tendency for the entrepreneurs, unless they are Islamically motivated, to borrow funds from the latter at fixed interest.[10]

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[9] Chawdhury, M.A. `Appraisal of Experience of Islamic Banks and their Future Prospective Role'. Unpublished paper presented at the First General Conference of Islamic Banks, Istanbul, October 18-21, 1986, p.11.

[10] Ariff M., `Islamic Banking in Malaysia: Framework, Performance, and Lessons,' **Journal of Islamic Economics** Vol.II, No.2 (1991), p.78.

The argument presented in the preceding paragraph can be supported by a study conducted to ascertain the attitudes of owners of businesses to Musharaka and Mudaraba financing techniques in the small scale manufacturing business sector of Saudi Arabia. The study showed that in the case of Musharaka finance, of the 211 respondents, 176 (or 83.4 percent) rejected the possibility of sharing ownership with the provider of finance.

This group of people prefer to remain sole owner(s) of the business and to be in a position to hand over the business to their heir(s) at a later date. Only 35 (or 16.6 percent) of the respondents are prepared to do so.The study further shows that 78 per cent of the respondents rejected **Mudaraba**. Of this percentage, approximately two-third fear eventual take over of the business by the financier and another 30 percent reject it because of management interference that the contract may entails.[11]

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[11] al-Hajjar, B. and John Presley, `Financing Development in Islamic Economics: Attitudes Towards Islamic Finance in Small Manufacturing Business in Saudi Arabia'. Unpublished paper presented at the Third International Conference on Islamic Economics, Kuala Lumpur, January 28-30, 1992, pp. 7-11.

It is important to point out here that this study has its own limitations. Therefore, the findings should be treated with caution. This is because the study is based on one country only. For one, a similar study in a another country with different financial setting may likely come out with different conclusions.

To be sure, there is nothing wrong with the short term risk free techniques of financing and their Islamicity is not in doubt because they do not involve interest. However, Ariff (1991, p.76) has pointed out that there is more to Islamic banking than being interest free. This is because the importance of equity financing cannot be overlooked. There is the urgent need to stimulate the private sector initiatives in the Muslim World.

Perhaps, the diversification of investment portforlios by Islamic banks can help in a way to address the problem of long term financing. From the onset, the desired objectives of Islamic banks should be clear. That is to pose the question whether Islamic banks should have profit maximization motive or development objectives. Although Islamic banks belong to the category of <u>tijari</u> (or the private sector), the real success of Islamic banking is to achieve social justice that can be achieved not through profit motive **per se** but by pursuing the development objective as well. If this role is accepted by Islamic banks, then there is the need to diversify their investment portfolios in order to go into long term financing. To achieve this objective, Islamic banks, especially the `old'ones, should put aside a certain percentage of their deposits (say 15% or 20%) for long term financing and the balance (80%) for medium and short term financing. In case of loss in the long term ventures, the bank can make it up from the profits of short and medium term financing. In this way, the banks can learn through trial and error with time.

4. Inadequate Operational Guides

Wilson (1990) argues that there are substantial areas to be clarified regarding the operational standards of Islamic banks to make their operations smooth. For example, the documentation of actual practice is meager and usually unpublished. There is also the problem of divergence of practice among Islamic financial institutions in the same line of business. In addition to this, the operational standards are inadequate. For instance "what are the criteria for deciding when Mudaraba (equity financing) is preferable to Musharaka (profit sharing)? Each bank has its own criteria but there is no internationally accepted guidelines".[12]

Another related problem is how to determine the profit sharing ratio which is supposed to replace the rate of interest in an interest-free economy and undertake the function of allocating scarce investible resources. An IDB study concluded that most of the Islamic banks arrive at the profit sharing ratio through bargaining (unilateral determination) as opposed to bilateral determination (on the basis of the nature of operation).[13] This issue should be addressed to enhance the development of Islamic banking and finance in the 1990's.

5. Absence of Common International Accounting Policies and Standards

This problem arises from the internal accounting policies and the requirements of local regulatory authorities (the central banks). Lack of common

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[12] Wilson, R., op cit., p.14.

[13] This conclusion was arrived at as follows. Several questions on the determination of profit sharing ratio were included in a questionnaire. Islamic banks were asked as to how they arrive at the profit sharing ratio. Two alternatives were provided: unilateral and bilateral approaches to determination of profit shares. In each case, Islamic banks were asked to choose any one applicable and describe specifically the one they adopt. See Ahmad, A., op cit., p.53.