

Islamic Banking System: Partnership in Sharing Business Risk

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Abstract

Purpose: The main purpose of this paper is to review and analyze the reasons why Muslims are now shifting from conventional banking systems to Islamic banking systems. The study in fact makes an attempt to clear some of the doubts and confusions in the minds of the Muslims who still believe that Islamic banking system is not free from interest (riba) as well. **Design/Methodology:** The methodology and design adopted in this study is basically analytical and its material is largely taken from the research papers written in this field. However, the study makes frequent use of secondary data to support logical conclusions arrived at in this study. **Contribution:** The study is helpful in creating greater confidence of the Muslims in using Islamic banking system as the first best solution in accordance with the principles laid down in Islamic Shari'ah. **Conclusion:** The author is fully convinced that the Islamic banking system offers greater security and entails lower failure risk while facing financial crises during different phases of business cycle.

Key words: conventional banking, riba, material, analytical and Shari'ah

1. Introduction

The banking system is becoming very crucial instrument in handling day-to-day needs of the society. When all the financial transactions in a society are performed through banking system, it will help country managers to formulate more effective monetary and fiscal policies in running the affairs of the economy.

Economists consider saving and investment, as the key functions in bringing stability in the economy.

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The banking system announces all those measures, which attract income earners to deposit their savings in the bank to earn a rate of return, which can pay them enough to cover cost of inflation plus some profit as income. To economist it is a legitimate earning of the saving community and must be treated as a business proposition. Actually banks are service providers with the sole purpose of earning as a business organization. However, the common man, whether he is a Muslim or a Christian, is in a state of confusion when dealing with the conventional banking system.

In conventional banking system, interest serves as a primary driving force for receiving money from its depositors and for lending money to the investors. Although other services such as funds transfers, securities and guarantees, credit notes and currency exchange and so on, which are equally valuable and form substantial part of bank's income, but they are largely considered as subsidiary functions of the banks. In fact, the conventional banks are established to serve the capitalistic system and are designed to make money by charging interest, which is completely forbidden in Islam and other revealed religions.

Islamic banking system offers services consistent with the principles of the Shari'ah (Islamic Law). Shari'ah prohibits all dealings where payment or acceptance of interest (riba) for the lending and borrowing of money is involved. At the same time according to Islamic Law, wherever business risk is involved the sharing of profit and loss in the deal is fully justified. In fact, Islamic banking system follows Islamic Shari'ah which demands justice for all "deal not unjustly, and ye shall not be dealt with unjustly" (2:279- Islamic Shari'ah). This principle emphasizes moral and ethical values in all dealings and is supported universally by the society.

Due to inability of the conventional banking system to meet financial crises and challenges in the past, both public and the conventional banking institutions are willing to give Islamic banking system a chance as a competitor in the banking industry. This is partly the reason that the Islamic banking system has registered a very high growth rate since its establishment.

This study is designed to provide a logical framework for establishing the rationale of introducing Islamic banking system as the first best solution to overcome the weaknesses of the conventional banking system.

The main theme of the study is to promote banking activities where ethical and moral values are followed to enhance saving and investment functions while sharing risk in each and every transaction offered by the banks.

2. Litratue Review

(Historical Events)

Western commercial (conventional) banking system was introduced about two and a quarter centuries ago. Initially it was generally believed that the commercial banking system did not contain the element of "Riba" prohibited in the Qur'an. In fact, many factors including complete ignorance from the Shari'ah Law, low level of literacy and the domination by the colonial powers made majority of the Muslim world unaware of the nature of working of the commercial banks.

Commercial banking system continuously expanded and more and more people started using its services. Meanwhile (around 19th century) a number of religious scholars while examining the dealings and the design of the commercial banking services offered to its consumers, found that often the loans given by the commercial banks were for consumption, which people found it difficult to repay and thus entailed hardships for the bank borrowers. This was a kind of situation, which very much resembled 'Riba' in Shari'ah Law.

Preceding the Great Depression (1929), banking organizations were operating with margin requirements of as small as 10%. Accordingly the banking organizations were doing business of lending \$9 for every \$1 it received as deposit. However, when the market fell, bankers tried to call these loans back but the response from the borrowers was very poor. As debtors defaulted the banks began to fail and depositors rushed to with draw their deposits en masse, resulting in multiple bank runs. After the panic of 1929, over 9,000 banks failed. In response to this large scale failure of the banking system in 1930s, many countries hurriedly increased financial regulation and established regulatory agencies to oversee banking operations. The emergence of International Monetary Fund and the IBRD (International Bank for Reconstruction and Development) during the post World War II was designed to provide necessary guidance to stabilize the economies in distress.

Whalen (1991) while referring to US banks over the period 1987-1990, found that banking failure risk increases with lower liquidity. His study showed that the risk of banking failure is difficult to control when the higher loans/assets ratio, higher operating costs and higher performing loan ratios are not kept at secure level. In the year 2007, mortgage lending to borrowers with poor credit resulted in a financial crises around the world. In fact, crises originated in the United States. As banking industry was highly globalized in this period, the financial institutions around the world received all the repercussions and consequently many financial institutions failed worldwide. The failure of a large number of major banks resulted in government bailouts and the central bank in these affected countries had to take substantial recovery measures to stabilize the banking system.

Banks have been in operation since 2000BC, when merchants used to give loans to farmers and traders selling goods between cities within the areas of Assyria and Babylonia for profit. However, banking system in the modern sense of the setup can be traced to medieval and early Renaissance Italy. It was in ancient Greece and during Roman Empire; lenders based in temples made loans and collected deposits. Although over all these years banking system has progressed a great deal in altering the fine points of the business model. A bank's primary purpose is to make loans and collect and protect deposits. This is likely to remain a fundamental function of the banks even in the future with all the changes brought about by the technology in the form of e-banking and so on.

Due to certain inherent risk of financial instability in the conventional banking system, there is a growing interest among the depositors to look for alternate business models. Islamic banking on account of its ethical appeal is steadily moving into an increasing number of conventional financial systems. Also on account of fast growing Muslim population in the world, Islamic investors (Gulf and Asia-Pacific region) are keen to diversify their portfolios. Thus Islamic banking is fast expanding not only in nations with majority Muslim population but also in other countries where Muslims are in minority, such as the United Kingdom, Australia, and Japan. Currently, there are approximately 300 Islamic financial institutions functioning in nearly 50 countries of the world. So far Islamic banking has experienced growth rates of around 10 – 15 percent per annum and this trend is likely to increase further.

Islamic banking is very much practiced like modern conventional banking with certain restrictions imposed by Islamic Sharia. These restrictions include the following:

Firstly, the benefit received by the institution by lending fund to the borrower for a specific time is not predetermined.

Secondly, Benefits received by the lender will be a share in the revenue that has been earned from the undertaking carried out by the borrower.

Thirdly, In Islamic banking individuals are not considered as creditors, they are associates in any undertakings.

Fourthly, taking of Riba (interest) is prohibited in Islamic banking.

Fifthly, contractual uncertainty and gambling (gharar & maisir) is unlawful in Islamic banking.

Sixth, prohibited industries such as those related to pork products and alcoholic beverages) are considered Haram and are not permitted in Islamic banking.

In Islamic banking the notion of interest on transactions is prohibited but it does not discard the time value of money. In fact, it offers the financier the benefits of a suitable income on money. In Islam individuals are refrained from carrying out any transactions that involve Riba (interest). According to Khan (2012) Islamic banks lend money to the borrowers on the basis of profit and loss sharing system, while transactions in Islamic banking is supported and backed by tangible assets.

A number of studies have been conducted to compare the performance of Islamic banks with that of conventional banks. But due to non--availability of requisite data from various banks, such studies are very few and limited in scope. The in-depth research carried out by the authors reveal the following observations:

The authors Parashar and Venkatesh (2010) in their studies compared performance of 6 Islamic banks and 6 conventional banks in the Gulf Cooperation Council (GCC) region for a period of 2006 – 2009. The performance indicators included capital asset ratio, cost to income ratio, return on average assets, return on average equity, equity to total assets and liquid assets to total assets. According to the final outcome of the study, Islamic banks have outperformed conventional banks in the GCC region during the period 2006 – 2009.

In a similar study Ansari and Rehman (2011) carried out performance analysis of Islamic and conventional banks based in Pakistan for the period of 2006 – 2009. The authors focused their study on several financial ratios, including profitability, liquidity, risk and solvency, capital adequacy, deployment ratio and operational efficiency. The authors in their study concluded that Islamic banks were less risky than conventional banks, even though Islamic banks were highly liquid and less operationally efficient.

The authors Pappasa, Izzeldine and Fuertesb of Alcaster (2012) in their study compared the hazard of failure in Islamic and Conventional banks taking 421 banks during 1995 – 2010 period. They found that Islamic banks have lower failure risk and are less interconnected which reduces the likelihood of domestic co-failure.

(Failure Risk in Islamic and Conventional Banks Vasileios Pappasa, Marwan Izzeldina, Ana-Maria Fuertesb;_Lancaster University Management School, UK. Cass Business School, City University London, UK . June 29, 2012)

The authors Beck, Kunt, Merrrouche of the World Bank Development Research Group in their study (2010) “ Islamic vs. Conventional Banking: Business Model, Efficiency and Stability” came with the conclusions that Islamic banks and conventional banks are not very different in business orientation, efficiency, asset quality or stability. They found Islamic banks rather more cost effective than conventional banks in a broad cross-country sample. However, they also came to the conclusion that this finding reverses in a sample of countries with both Islamic and conventional banks. In their findings it was also pointed out that there is a consistent evidence of higher capitalization of Islamic banks and this capital cushion plus higher liquidity reserves explains the relatively better performance of Islamic banks during recent crisis.

3. Methodology and Design

The study makes an attempt to address the concept of ‘riba’ (interest) in Islam and its implication for the Muslim population to use conventional banking system. The design of this research paper entails an in depth study of the conventional banking system vis-à-vis Islamic banking system to demonstrate their strength and weaknesses. This was essential to find satisfying solution for the users of banking services in general.

However, the main objective of this study is to clear some of the doubts and confusion in the minds of the Muslims that Islamic banking system is not completely free from 'riba'. This being an analytical study, much of the discussion in this study is based on the research papers written in this field. The secondary data is used at places during the discussion to support the logical conclusions on various points.

4. Disucssion and Analysis

Islamic banking system claims to present a progressive business plan very much in line with the teaching of Islam. The origin of banking is traced back to the very birth of Islam during which Prophet (PBUH) himself worked for his wife in carrying her trading operations. It was a true pattern of partnership where the owner supplying capital while the Prophet (PBUH) provided labor and management capability to run the business. Each partner shared the responsibility in an agreed and pre-determined split of the profit and loss. There are over 1.6 billion Muslims around the world, of these nearly 62% live in Asia-Pacific, approximately 20% in the Middle East- North Africa, 15% in Sub-Saharan Africa, while only 3% live in Europe and America. In fact, more Muslims live in India and Pakistan (344 million combined) than in the entire Middle East-North Africa region. Majority of these Muslims are keen to see that their banking needs are handled strictly in accordance with the teaching of Islam.

Initially the Muslim world was generally believed that the commercial (conventional) banking system did not contain the element of "Riba" (interest), because taking of interest (Riba) is strictly prohibited in the Qur'an. This understanding among Muslims may be due to several factors, including low level of literacy, complete ignorance from the Shari'ah Law, and domination by the western powers. It was around 19th century that a number of religious scholars while examining the dealings and the design of the (conventional) commercial banking services offered to its customers, found that the loans given by the commercial banks were often for consumption, which people found difficult to repay and thus entailed unbearable hardships for the bank borrowers. This aspect of the commercial bank dealing very much resembled "Riba" in Shari'ah Law.

The word "Riba" is explained in the Holy Quran and it denotes the amount of payment that a lender receives from the a borrower at a fixed rate in excess of the principal. In Judaism and Islam it is forbidden to charge interest at all. Similarly in Christianity it is said, "Do not charge your brother interest, whether on money or food or anything else that may earn interest." (Deuteronomy 23:19).

The Islamic banking system (IBS) is based on risk sharing which is a crucial component of business. The IBS also permits profit sharing (Mudharabah), safekeeping (Wadiah), joint venture (Musharakah), cost plus (Murabahah), and leasing (Ijar). Evidences suggest Islamic banking is very much practiced like modern conventional banking with certain restrictions imposed by Sharia and addresses the large number of business requirements successfully. A few business transactions are explained below:

1. Islamic bank may lend money to investing business firms by issuing floating rate of return. This floating rate of return is pegged to the business firms individual rate of return. Thus the Islamic bank's profit or loss on the loan is equal to a certain percentage of the business firm's profits and loss. This practice is called Musharaka.
2. The Islamic bank may provide (venture capital) funding to an entrepreneur who offers labor skill and management capability, so that both profit and loss are shared. This kind of partnership between capital and labor skill is justified in IBS on the ground that the borrower must not bear all the cost of a failure. This kind of participation is called Mudaraba.
3. IBS practices nearly full-reserve banking with Islamic banks achieving very high reserve ratio.

4.1 Failures of Conventional Banking System:

Recently (Year 2007) a number of conventional banks and financial institutions in the US economy experienced massive losses on mortgages and mortgage-backed securities. These crises caused panic and financial turmoil around the world. The mortgage crises were largely associated with the failure of conventional banking system and it was outcome of too much borrowing and flawed financial strategy. The circumstances in USA were such that in the early 2000s, due to low mortgage rates, demand for borrowing funds increased dramatically. Later with home prices skyrocketing, homeowners became very rich.

This encouraged many homeowners to use their homes as collateral and took second mortgages to get cash out of their homes' equity. The mortgage crisis was triggered when this situation built momentum and resulted in global financial crises.

Simons advancing some of the reasons for the instability of the conventional banking system, suggested that the basic flaw that as a crisis develops and earnings fall, banks make loans to increase their reserves, but each bank can do so only at the expense of other banks and thus some banks become insolvent. Simons (1948) defended a 100-percent reserve ratio with the sole purpose of ensuring complete government control over the quantity of money in circulation. Milton Friedman (1959) in his publication "A Program for Monetary Stability" while reviewing credit expansion on account of fractional reserve recommended that the current system be replaced with the one, which includes a 100-percent reserve requirement. Very many highly distinguished economists of twentieth century, such as Ludwig von Mises, Friedrich A. Hayek and James Tobin have at some point fully defended the establishment of a 100-percent reserve requirement on demand deposits placed at banks. More recently Pollock (1993) again defended a similar banking system in his article "Collateralized Money: An Idea Whose Time Has Come Again". He is of the view that reserves should be held not in money but in assets with a market value that makes them easy to liquidate.

Edwards and Mishkin (1995) in their paper "The Decline of Traditional Banking" argued that the traditional banking system is subject to decline on account of making loans and funding them by issuing short-dated deposits. The authors were of the view that the traditional banking may threaten financial stability by increasing the incentives for banks to take on more risk, either by making more risky loans or by engaging in 'nontraditional' activities that promise higher returns but greater risk.

4.2 Performance of Conventional and Islamic Banking Systems

The comparative studies carried out by various institutions and the authors reflecting performance levels of conventional and Islamic banks so far provide sufficient evidence (Literature Review-Section 2 above) to show that the Islamic Banking System and Conventional Banking System are not very different in business orientation, efficiency, asset quality or stability.

There is overwhelming proof that Islamic banks have lower failure risk and they are relatively more cost effective when compared with the Conventional banks.

4.3 Stability Features of Islamic Banking System

Lending money to the needy for consumption is highly desirable act, which must be satisfied without exception. By needy we mean those who cannot afford to have two meals a day (basic minimum food intake considered necessary for human living). The primary responsibility for providing money to the needy for consumption rests with the state. In the western countries, all such needy people are given financial support to maintain a minimum level of living in the society. So they do not need to borrow money for consumption.

In developing countries, majority of the needy people borrow money for day to today consumption. Due to lack of state support, they end up borrowing money from private moneylenders at exorbitant charges (usury). Such borrowings create misery and unending poverty among the poor people. Usury is prohibited in Islam as well as in all the revealed religions (Christianity & Judaism). In these circumstances, Islam completely forbids taking interest in any form. As the conventional banks are dealer of money; and reward for using money is interest in the capitalistic system; so the prime source of revenue and cost of funds to conventional banks is charging interest. In fact, interest is the major driver of operations of conventional banks although the conventional banks also provide other valuable services including transfer of funds etc.. Charging of interest is prohibited in Islamic Law, so Muslims left with no choice except to establish their own financial institutions according to teaching of Islam.

The first Islamic Interest-free bank (Myt Ghamr Savings Bank) was established in 1963 in Egypt and became a highly motivating force to spread interest-free banking in many countries in the world. Since then Islamic banking is growing rapidly in Muslim countries as well as in western countries. The available estimates suggest that the volume of Islamic banking has reached nearly USD 951 billion (Year 2008). Middle East is the international hub of Islamic banking with contribution of approximately 80% while the rest of the world contributes 20% share.

4.4 Islamic Banking System as a Trend Setter

The early 1970s saw greater institutional involvement around the world. The conference of the Finance Ministers of Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, the first International Conference on Islamic Economics in Mecca in 1976, and the International Economic Conference in London in 1977 were the instrumental as the involvement of institutions and governments led to the application of theory to practice and resulted in the establishment of the first interest-free banks. The Islamic Development Bank, an intergovernmental bank established in 1975, was born of this process.

The Banker (November 2010) published its authoritative list of the Top 500 Islamic Finance Institutions in the world. Seven out of top ten Islamic banks in the world are Iranian according to the list. In the year 2009 Iranian banks accounted for about 40 percent of total assets of the world's top 100 Islamic banks. Bank Melli Iran, with assets of USD 45.5 billion came first, followed by Saudi Arabia's Al Rajhi Bank, Bank Mellat with USD39.7 billion. Iran holds the world's largest level of Islamic finance assets valued at USD235.3 billion. Islamic banking has been making headway into an increasing number of Western countries. Trend News Agency (May 2012) in their report revealed that the chairman of the International Bank of Azerbaijan is to expand into Islamic banking services. This expansion is to cover Russia and Kazakhstan as well with the intention of making Azerbaijan a regional center for Islamic financing.

Islamic banking has been spreading and making headway into several Western countries. Some of the world's biggest banks, like Citigroup and Deutsche Bank, have established Islamic banking arms. Australia, the second among 55 of the world's leading financial systems and capital markets (World Economic Forum) is vigorously campaigning to introduce Islamic banking among the masses. National Australia Bank and Westpac have announced Islamic banking services to their customers. La Trobe is the first Australian university to offer master programs in Islamic finance. This trend is likely to carry on, as oil-exporting countries continue to accumulate wealth and businesses in Western nations keep on competing to attract international investors.

5. Conclusions and Recommendations

In accordance with the Islamic Law charging interest (Riba) is prohibited in the Islamic banking system. Therefore, Muslim community, all over the world, likes to refuse accepting any deal in which 'Riba' is involved. Even in cases where it is difficult to identify presence of riba, it is better to transact through Islamic banking system and let them have the responsibility to safeguard their operations from riba as far as possible. When banking with Conventional banking system, a Muslim is solely responsible for dealing in forbidden act of riba (interest) and is to respond for the violation of Islamic law on his own. Even if at some stage under Islamic banking system, some form of riba is considered unavoidable, the Islamic institution itself will have to take responsibility to respond for all such sinful transactions.

There are about 1.6 billion Muslims in the world. Many of these Muslims are keen to avoid 'Riba' in their transactions with the banking system. The available estimates suggest that the volume of Islamic banking has reached nearly USD 951 billion (Year 2008). All this is largely coming from the Middle East and Iran. In fact, seven out of top ten Islamic banks in the world are Iranian. Available evidence suggests that simply on merit basis, Islamic banking is gaining popularity among Muslims all over the world.

Conventional banking system met several set backs in the past. For example during depression of 1929/30, run on the banks brought failure to over 9000 banks. In the year 2007, mortgage lending created financial crises around the world. Thus due to inherent risk of financial instability in the conventional banking system, there is a growing interest among the depositors to look for alternate banking system. Islamic banking system due to its ethical appeal and greater reliability, is now seen favorably as compared to the conventional banking system. The Islamic banking system is based on risk sharing which is a crucial component of business. At the same time Islamic banks operate on a very high reserve ratio to remain solvent to face financial challenges and crises during different phases of business cycle. This is one of the crucial points in favor of Islamic banks, which has actually reduced the failure risk of the Islamic banking system.

The very basic operational model of Islamic banking system provides a form of partnership where one party provides the funds while the other provides expertise and management. The risk of failure logically is to be divided between these two complementary operations on some agreeable terms and conditions.

This is a fair business proposition and equitable to all concerned. By holding very high reserve ratio, the Islamic banking system ensures safekeeping of funds for those who provide their savings for investment to the bank. So far the past experience shows that Conventional-banking system has frequently threatened the stability and creditability of its operations during crucial phases of business cycle. This is becoming a major reason that more and more people are considering to use Islamic banking system for there banking needs.

The comparative studies carried out by various institutions and the authors reflecting performance levels of conventional and Islamic banks so far provide sufficient evidence to show that the Islamic Banking System and Conventional Banking System are not very different in business orientation, efficiency, asset quality or stability. However, all these studies do point out that Islamic banks have lower failure risk and they are relatively more cost effective when compared with the Conventional banks.

Islamic banking is widely spreading all over the world and making headway into several Western countries. Some of the world's biggest banks , like Citigroup and Deutsche Bank, have established Islamic banking arms to serve masses. Australia, the second among 55 of the world's leading financial systems and capital markets (World Economic Forum) is vigorously campaigning to introduce Islamic banking among its banking community. Recently National Australia Bank and Westpack have announced Islamic banking services to their customers. La Trobe is the first Australian university to offer master programs in Islamic finance. This trend is likely to carryon, as oil-exporting countries continue to accumulate wealth and businesses while Western nations keep on competing to attract international investors.

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