

# **PROGRESS OF ISLAMIC BANKING: THE ASPIRATIONS AND THE REALITIES**

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## **1. INTRODUCTION**

Given the long history of contemporary banking business, Islamic banks are considered to be relatively new institutions. Their achievements are rather modest, relatively to the great hopes attached to them in Islamic economic thought. This is a natural outcome for those who aspire to come close to perfection, for real perfection is an exclusive attribute of Allah, the Almighty.

In this paper an attempt has been made to evaluate the experience of Islamic banking over the past thirty years and to answer some of the questions relating to Islamic banking.

Anyone attempting to evaluate the experience of Islamic banking has to recognize the circumstances under which these banks have been working. Broadly speaking, the experience of Islamic banking can be classified into two categories: (a) Islamic banks co-existing with interest based banks and (b) Islamic banks operating under a binding and all-embracing Islamic banking system.

Under the first category, there may be a single Islamic bank operating in a country, such as the Jordan Islamic Bank in Jordan, and many other national Islamic banks or more than one Islamic bank operating in the same country as in Egypt, Qatar, Bahrain and Bangladesh.

These banks practice Islamic banking within the framework of the hegemony of the interest based banking system, as far as their work or integration and the support guaranteed by the credit system are concerned. In addition to these specialized Islamic banks, the practice of the conventional banks providing some forms of Islamic financing and investment to their clients, has emerged. These conventional banks have opened what is called "Islamic windows". This is the case in Malaysia, the Islamic Transactions branches of the Bank of Egypt and the Islamic Services branches of the National Commercial Bank, Saudi Arabia. It is worthwhile mentioning in this context that some of the banks that are registered and are doing business in non-Islamic countries are also

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engaged in certain types of Islamic transactions. Moreover, there are also a number of Islamic banks that are registered in non-Islamic states such as Denmark and Luxembourg.

Under the second category, come the banks in Sudan, Pakistan and Iran where attempts are underway for Islamizing the entire banking system. As far as Iran is concerned, all banks have been nationalized since the inception of the Islamic Revolution while Pakistan and Sudan have governmental banks as well as banks owned by the private sector. The issue of nationalizing the banks in Iran was subject of serious discussions among the scholars belonging to the Imamate School until the opinion calling for nationalization won the battle .

Keeping this background in view, we will, in the following section, deal with some questions/objections with respect to the theory and practice of Islamic banking at the micro level. In section three, we will address some issues relating to a comprehensive Islamic banking system at a country-wide level.

## **2. THEORY AND PRACTICE OF ISLAMIC BANKING AT MICRO LEVEL**

In spite of three decades of the operation of Islamic banks, the topic of Islamic banking is still subject to queries, whether from university students, professors of economics, financial administrators or businessmen. These questions relate both to the theory as well as the practice of Islamic banking. We will discuss them in turn.

### **2.1 Queries about the theory of Islamic banking**

#### **A. Is there any scope for banking business in an Islamic economy?**

Some of those who are enthusiastic about maintaining an independent appearance of Islamic institutions ,raise the issue of banking business, right from its fundamentals. A group of these enthusiasts is of the view that the idea of Islamic banks is nothing but a classic imitation of the interest based banks. They are of the view that there is no room for banking business in Islam and that the Muslims do not need banking institutions as the treasury) *Beit-ul-Mal* (occupies the place of these institutions. Is this really so?

To start with, one has to realize that the Islamic economy is a cash based economy. This is well established from the incident wherein the Prophet (pbuh) directed

Bilal (may Allah be pleased with him) to sell the dates of second grade on cash and then buy first grade dates on cash instead of exchanging them with one another directly .

Reading the economic history of the Islamic civilization, one easily realizes the room for banking. Those who call for alienation from the suspicion of imitation are in need of enlightenment in the methodical logic of the concepts of the Islamic *shari'ah* and the derivation of its provisions in what is permissible) *halal* (and what is forbidden) *haram* .(When the Prophet (pbuh) was sent, the people were doing business by participation, usury, bargaining and bidding in sales as well as by other transactions in the form of agreements, betting and gambling.

The approach of the Islamic *shari'ah* was clear: it approved dealings that conformed to the *shari'ah* and nullified those that violated it. Thus, usury was annulled and legitimate sales were approved. Contractual agreements were based on the legitimate origin of contracts, namely, the principle of mutual agreement without unfairness, fraud, monopoly or swindle.

In this way *shari'ah* controls of financial dealings were able to fulfil the needs of the community in Al-Madinah Al-Munawwarah. These controls did not fail to meet the needs of the new regions when conquests reached Syria, Egypt, Persia up to Bukhara, Tashkent and Samarkand.

When the need for exchange of money and transfers arose, money changers began to emerge. They were subject to their own regulations and controls to the extent that Imam Malik Ibn-Anas) may Allah's mercy be upon him) drew the attention of the public to the fact that it was not permissible for a Muslim to become a money changer unless he knew the provisions of "*halal* "and "*haram* "in financial dealings .

Thus, Islamic civilization came to know right from the first era of Islam of the system of money transfers from Makkah and Madinah to Kufah and Al-Basra. Then, further developments took place and money changers opened their own offices from which transfers and instruments of payments used to be drawn. These were the origin of cheques. Sayf al-Dawlah al-Hamdani was the first recorded person in banking history to issue a cheque for clearance between Baghdad and Aleppo .

Those who deny any scope for banking business in the history of Islamic civilization because banks did not exist in their present forms, are like those people who say that people in the past did not travel since they did not have cars or that people did

not know how to build houses because they did not have cement and steel factories. Banking business is a genuine need of the society and what is important is not the form of the bank but the work it does. Every type of work has its own criterion in Islam and it is accepted or rejected on the basis of its compliance with the provisions of *shari'ah*. Banks are mere means for the execution of business and as such, the means do not become "*halal*" or "*haram*" since the work for which the means are used is the ultimate criterion.

## **B. Should Islamic banks act as traders?**

Some people who are not very well acquainted with the banking business, and a few of those who are in the administration of Islamic banks, think that the Islamic bank must work like a merchant who has stores, goods and his own companies engaged in the transportation, loading and unloading of goods, etc.

This need not be the case. As a matter of fact, an Islamic bank is like a traditional bank in that they are both financial intermediaries. A banker is not a businessman. The function of a bank, as dealt with by Muslim jurists, is like that of a *mudarib*. Financial intermediation does not violate *shari'ah* rules. Islamic banks utilize the funds of the community for the benefit of the same community within the legitimate framework of partnership between capital funds and human efforts. What is important is to do business with these funds in accordance with the divine *shari'ah*. If the Islamic bank is a merchant, then, what would be left for the community of ordinary merchants to do? The bank would, with its financial strength, monopolize the market and force the merchants out of the market.

## **C. Are Islamic banks mere *heela* (legal stratagem) to circumvent the *shari'ah* rules prohibiting *riba*?**

Some people contend, without any proof, that Islamic banks are a mere legal stratagem to circumvent *shari'ah* rules prohibiting *riba*. These people cite examples and cases which are exaggerated. Among these, for example, is the claim that *murabahah* is a mere stratagem to lend with interest, especially when one takes into consideration that the profit margin in a *murabahah* contract is the same, if not even more, as the prevailing interest rate. Another example is the claim that Islamic banks deal with foreign banks on interest basis or on the basis of a nominal (*murabahah*) partnership). These contentions are without any proof. Islamic banks bear a large responsibility for the clarification of the picture at all times and for keeping away from areas of suspicion with devotion and consciousness.

## **2.2 Some reservations with respect to the practice of Islamic banking**

In spite of their recognition of the soundness of the theoretical basis on which Islamic banking rests, some people criticize Islamic banks for not being able to achieve their intended objectives due to deviations in application. The criticisms levelled against Islamic banks can be summed up in the following points:

### **A. Excessive resort to the *murabahah* mode and the neglect of the other legitimate modes of financing**

This criticism is repeatedly levelled against Islamic banks and although it is valid, yet, it is not a violation of the injunctions of *shari'ah* as long as the *murabahah* contract is correct from the *shari'ah* point of view and is free from intentional or nominal deception.

Selling is a lawful action and what Allah permits, man cannot prohibit. It would, however, have been much better, if Islamic banks were able to distribute their investments over various possible forms such as *mudarabah*, *musharakah*, *salam*, advance-sale and leasing. This would have been optimum from the viewpoint of the soundness of the work and dealings.

### **B. Utilization of the interest rate for fixing the profit margin in *murabahah* sales**

Many critics blame Islamic banks for utilizing the interest rate as a criterion for fixing the profit margin in the *murabahah* sales.

As a matter of fact there is no known way of avoiding the link up with this criterion as long as Islamic banks are operating within an environment where they coexist with traditional banks. But, what is required of Islamic banks is to avoid exceeding the prevailing interest rate or exploiting the clients through accounting methods which some of them employ, which involve calculation of the absolute profit rate while paying no consideration to the installments paid during the year.

### **C. Indifference towards the social aspects of financing**

Islamic banks that do business within the climate of coexistence with traditional banks are blamed for pursuing the traditional course that is being followed by the conventional banks. They tend to concentrate on extending credit facilities to well

established commercial establishments which often obtain credit facilities from both conventional as well as Islamic banks without real commitment or attempt to free themselves from the prohibited) *haram* (means of finance. In this way, Islamic banks have in general become a figure that is added to the number of traditional banks which do business in the country concerned. No clear signs have so far emerged on the role of Islamic banks in the promotion of new projects needed by the society, like enabling those who have no property, providing employment opportunities to all categories of people, demonstrating the impact of Islamic investment on the solution of the unemployment problem and assisting the State in confronting these ever-increasing problems.

Moreover, Islamic banks did not pay much attention to the development of banking services in some socially desirable directions, except in very rare cases. The entire realm of the management of estates, trusts and orphanages, etc., has remained outside the area of interest of Islamic banks, in spite of the fact that a number of Western banks have, since the sixties, begun establishing specialized departments for Estates and Trusts.

#### **D. Lack of positive response to the requirements of governmental financing**

It is a well known fact that the modern state is always in need of funds and resources to implement useful projects, such as the provision of schools, roads, electricity and water and telecommunication services. Generally, governments resort to issuance of treasury bills with interest in accordance with the form used by conventional banks .

Islamic banks are required to enter into this field so as to prove their ability to play their role in the financing of projects in a manner that conforms to the Islamic system through the issuance of deeds of *murabahah*, *musharakah* ,advance-sale ,*salam* and such other forms that would satisfy the needs of the state for financing and, at the same time, benefit from investment of their idle liquid surpluses.

#### **E. Failure of Islamic banks to establish co-operation among themselves**

In spite of their good intentions, Islamic banks are blamed for their lack of open-mindedness to one another, a state of affairs that obstructs the achievement of mutual cooperation among them. This is in spite of the persistent endeavours of the Islamic

Development Bank to bring them closer to one another and unify their stands. Following examples are enough to prove the point:

- Not all Islamic banks are members of the International Association of Islamic Banks. The Association has neither been able to unify their regulations, nor build bridges of confidence and promote understanding amongst them.
- The idea of establishing a "Bank of Islamic Banks" is still mere an idea, although there is an urgent need for its establishment. As a result of its absence, Islamic banks have lost hundreds of millions with the collapse of the BCCI.
- Islamic funds continue to sneak out by hundreds of millions into investment houses doing business in the West while the Muslim world remains thirsty for investment resources.
- Funds of expatriates from Islamic countries do not find their way back to their own countries to contribute to the development of their original homelands.
- Trade among countries of the Muslim world is completely paralyzed as the Islamic financing system goes along with the traditional trend in financing imports from foreign countries without giving any preference to products of the Muslim world. Only the Islamic Development Bank has been paying due attention and care to the need for preferential treatment for the products of Muslim countries .

### **3. ISSUES IN A COMPREHENSIVE ISLAMIC BANKING SYSTEM**

It was not possible for contemporary researchers to conceive at the beginning of their research on the working method of Islamic banks that the optimal opportunity would come before the end of the Twentieth Century and that a comprehensive Islamization of the whole banking system would take place in more than one Islamic state. It is not strange, therefore, that one does not find an all-inclusive framework for the integrated Islamic banking system, in spite of the fact that this opportunity, which is now in hand in three Islamic states, requires extending the basis of the Islamic banking system to its well-integrated form. Some relevant issues are discussed in this section.

### **A. The ownership of banks: should banks be owned by the public or the private sector?**

The issue of banks' ownership constitutes an important part of the economic role of the State and the extent of its intervention in the activities of individual citizens. In principle, people are free in what they may own and what businesses and institutions they may establish in compliance with the provisions of the *shari'ah* and guaranteeing the safety, security and peace of the society. This does not, however, prevent the State from complementing those activities which individuals are reluctant to undertake, such as the establishment of banks that specialize in financing of agricultural, tourism and housing projects.

What is important in the case of Islamic banks - whether owned by the State, individuals or by the private and public sectors jointly - is that they must abide by the system and be subject to the directives of the monetary authority regarding the planning of credits, sectoral distribution of investment, fixing of profit margins and participation ratios and cooperation with the State in safeguarding the country's economy, monetary strength and the exchange rate.

### **B. Sectoral complementarity within Islamic banking**

Normally, the private sector has a tendency for establishing commercial banks and refrains from establishing specialized banks, particularly those engaged in financing of agriculture, industry and housing projects.

Sectoral complementarity makes it imperative upon the State to establish, through the public sector, specialized banks to whose capital the commercial banks must contribute. Such specialized banks will, therefore, be jointly owned by the public and the private sectors.

The monetary authority would fix the ratios of deposits from the current and investment fund accounts - which the commercial banks must deposit with the specialized banks.



### **C. Utilization of the profit margin and participation ratios as instruments for directing credit**

When there are no conventional banks in a country, the interest rate must automatically disappear from the market as it is not permissible even for a specter of interest to exist.

The alternative here is to determine through economic study within the social context, the profit-margin in *murabahah* or the participation ratio in *mudarabah* and in all other partnerships that end with the ownership of the project. The monetary authority represented by the Central Bank or the Monetary Agency will have the final authority to determine the profit margins in all the kinds of commodities.

If one considers the profit margin in a *murabahah* contract, one finds that the merchant considers the mark up that he pays when he buys the goods on credit to be part of the cost and adds it to the price of the goods when he sells them. Therefore, the reduction of the *murabahah* profit margin on foodstuffs such as wheat, rice and vegetable oil, helps in the reduction of the cost of living for low-income categories of the society. In exchange, there is a possibility of raising the *murabahah* profit margin on luxury items such as television sets and domestic electrical appliances. In this way, the objective of supporting the low-income categories and reducing unnecessary spending on imports can be achieved.

With regard to participation ratios, these could vary in different kinds of projects. For example, for wheat mills the monetary authority may fix the participation ratio for the bank at no more than 20% of the profit and 80% for the partner, while the share of the bank in a chocolate factory may be higher, say 50%. The bank should then also be subject to restriction of the overall credit facilities that it could extend so that its administration may not prefer financing of chocolate factories and neglecting the needs for wheat mills, and so on. The *fiqh* framework for dividing the profit among partners in accordance with ratios mutually stipulated in the contract also permits fixing of a maximum share of the bank, for example, 15% of the profit realized, if this is deemed to be in public interest.

#### **D. Requiring all banks in a country to cooperate in centralization of risks, insurance of deposits and guarantee of investment risks**

This could be achieved by implementation of the rules of cooperative insurance as is directed by Islamic *shari'ah* to avoid concentrating funds in the hands of a small group of people in society and depriving the majority of opportunities to enter the world of *halal* business.

#### **E. Studying amendments required in the laws relating to companies, commerce, investments and the relevant courts**

A comprehensive system of Islamic banking needs legal protection. This requires a thorough review of all relevant laws having a bearing on banking business. It is not sufficient to amend the banking and credit laws only. Also required is consideration of amendments needed in the laws relating to companies, commerce, investment and the relevant courts and legal procedures.

It is not advisable for company law to continue to deal with joint liability companies and trusts of French origin while neglecting the type of firms permitted by Islamic *fiqh*, such as sleeping partnerships and the " *Al-Anan* Company", in which the capital funds of all partners are equal but the profits are different and vice-versa, and companies that have no capital but buy on the basis of trust that people have in them and make the required payments when they sell the same goods) *Sharikat Al-Abdan Wal Wujuh*. (It is also not acceptable that company law continues to talk about bonds and interest while ignoring participation deeds and profits. Investment promotion laws should not mention the tax privileges and reduced interest rates. The same is also true of legal procedures needed by the Islamic banking system so as to avoid premeditated delay by rich people in settling due rights, as is the case in the civil courts in a number of states.

#### **F. Social role of Islamic banks**

The existence of a well integrated Islamic banking system makes it imperative that it meets different requirements of the society. The most important area of interest in this regard is the administration of funds of orphans, estates and trusts. Islamic banks which administer the funds of adults can also establish an independent administration for the funds of orphans and widows and advise them as to their financial rights and the best ways to invest the funds they have inherited.

It is pertinent to mention here that Islam directs wards of orphans to put orphans' funds in income generating investments so that they may not be exhausted by payment of *zakah*. Islamic banks are nothing but specialized investment institutions for such matters.

### **G. Introduction of an Islamic capital market and instruments of financing, and investment on the basis of participation and trading**

The objective here is to provide the banks with the means by which they can invest the surplus liquidity they have and to enable the State to finance its needs for development projects through interest free instruments.

When Islamic financial instruments are made available at the national level, those individuals who do not like the performance of Islamic banks could turn to investment in government financing instruments, as long as they are *halal*. Faced with such competition Islamic banks will begin to look for more profitable avenues for investment which are also socially desirable. In this way, the interests would intertwine and help achieve the complementarity in a spirit of commendable competition.

### **H. Attracting expatriates' remittances, and capital investment outflows**

The Islamic banking system must be based on the concept of safety and security. Once security of investment is assured, and if there is peace and security, there would be no need for the migration of funds abroad. A Muslim is not afraid for his funds inside his country as long as he is sure of optimum investment of his capital and its safety from expropriation. In spite of all this, the Islamic system does not prohibit the movement of capital as long as it is engaged in a *halal* business.

### **I. Providing equitable opportunities for acquiring bank credit**

The concept of equality among all citizens requires the existence of opportunities for all individuals to acquire the capital necessary for production. The driver, engineer, farmer and medical doctor all have a right that the society should ensure for them the means to work in the fields they are qualified in. Islamic banking system is not based on the principle of "What do you have, so that we could give you"? It is based on, "What can you do"? If the opportunity is offered, production would increase and prices will come down. Exports will increase and the balance will be in favour of the country, in general.

## **J. Achievement of economic integration among all countries of the Muslim world**

Islamic banks doing business under the comprehensive system of Islamic banking should undertake to direct their activities towards the development of cooperation with states of the Muslim world and the Islamic banks operating in them.

As far as imports are concerned, priority in the financing, pricing, and profit margins should be given to the products of an Islamic country. The same is true as far as exports are concerned. Joint and complementary projects with other Islamic countries should be given priority in financing and execution. In the same way, Islamic banks must enjoy the optimum care and sponsorship in all fields. Investment capital from an Islamic country must have the same privileges as the national capital .

In conclusion, we can say that the aspirations of Islamic banking have not been fully realized yet. Islamic banks have a long way to go. They should rid themselves of the blemishes in some of their activities. Islamic banking will remain subject to some criticism until such time that Islamic bankers prove that they are able to serve the Muslim *ummah* and the humanity in general with new instruments based on justice and fairness.