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Islamic Banking*

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Abstract

Islamic banks are prohibited from charging or paying interest, and thus can operate only on the basis of profit-sharing arrangements. This paper provides a brief survey of the theory and practice of Islamic banking. It covers developments in Islamic banking since the mid-1970s, how such banks operate, and the analytical underpinnings of a financial system based on Islamic principles. Finally, the future of Islamic banking is assessed.

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In Islam there is an absolute prohibition against the payment and receipt of interest (the Arabic term for which is riba). It is this prohibition that makes Islamic banking differ in a very basic and important way from a conventional banking system. 1/ As the use of the interest rate in financial transactions is precluded, Islamic banks can operate only on the basis of profit-sharing arrangements or other modes of financing permissible under Islamic law (the Shariah).

Technically, riba refers to the addition in the amount of principal of a loan based on the time for which it is loaned and on the amount of the loan. From a legal standpoint, it signifies the additional money charged in money-to-money transactions or the extra commodity in commodity-to-commodity operations. While earlier there was a debate as to whether riba referred to interest or to usury, it appears there is now a consensus of opinion among Islamic scholars that the term extends to all forms of interest, and without distinction being made between real and nominal rates. The fundamental sources of Islam, namely the Qur'an and the Sunnah (the teachings and traditions of the Prophet Mohammed) do not provide a detailed explanation for the prohibition against interest beyond asserting, axiomatically, that charging interest is an act of injustice and thus forbidden. Contemporary Muslim economists have, however, provided various rationales for this restriction by appealing to the supposedly adverse consequences of the existence of interest in modern societies, or by asserting that interest is exploitative, or by arguing that modern economic theory has not provided a justification for the existence or need for interest, and furthermore, that interest is inconsistent with the Islamic notion and concept of property rights (Chapra 1982; Siddiqi 1983; Ahmad 1984; Khan and Mirakhor 1989). A universal view on this issue is as yet unavailable.

1. Development of Islamic Banks

Although the restriction against the use of interest would seem to be a binding constraint, Islamic banks and financial institutions have in fact grown rapidly, particularly since the mid-1970s. At present there are about 45 countries, encompassing most of the Muslim world, that have some type of Islamic financial institution. This development in Islamic banking has basically taken two forms. The first has been an attempt to establish Islamic financial institutions side by side with traditional banks. In such attempts, the types of institutions that have evolved are Islamic banks established mostly in Muslim countries, and Islamic investment and holding companies operating in some Muslim countries, but mostly in non-Muslim countries. In both cases, generally, the banking operations are subject to regulations that apply to all banks. Examples of Islamic banks in Muslim countries include the Faysal Islamic Bank of Bahrain, the Faysal Islamic

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1/ For a detailed description of Islamic banking, see Iqbal and Mirakhor (1987).

Banks in Egypt and the Sudan, the Dubai Islamic Bank, the Qatar Islamic Bank, and the Jordan Islamic Bank. Examples of investment companies having either a national or an international mandate include the Dar al Mal al Islami (Geneva), Albarakah International Ltd., (London), the Islamic Investment Company (Bahamas), and the Al Rajhi Company for Islamic Investment Ltd., (London). These international institutions, which are generally privately owned, compete with conventional banks for deposits--but without paying interest--and invest these funds wherever they find profitable investment opportunities.

The second form that the development of Islamic banking has taken involves the restructuring of the whole financial system in accord with Islamic concepts. The countries where this transformation of the system has occurred are Iran and Pakistan. In Iran all banks operate under Islamic law, while in Pakistan only foreign banks are exempt from the restriction against interest-based transactions (Khan and Mirakhor 1990).

2. Operations of Islamic Banks

As discussed by Khan and Mirakhor (1989), besides their own capital and equity, Islamic banks rely on two main sources of funds--transaction deposits and investment deposits. Transaction deposits can be regarded as equivalent to demand deposits in a conventional banking system. Although the Islamic bank guarantees the nominal value of the deposit, it pays no return on this type of liability. Generally speaking, funds mobilized through this source cannot be used for profitable investment by banks. As such, banks can levy a service charge on deposit holders to cover the cost of administering this type of account.

Investment deposits--also termed profit-and-loss accounts--constitute the principal source of funds for banks and they more closely resemble shares in a firm, rather than time and saving deposits of the customary sort. Investment deposits carry no guarantee on their nominal value, and do not pay a fixed rate of return. Depositors, instead, are treated as if they are shareholders (as in a mutual fund or investment trust, for example), and therefore are entitled to a share of the profits or losses made by the bank. The sharing-ratio has to be agreed in advance of the transaction between the banks and the depositor, and cannot be altered during the maturity of the transaction, except by mutual consent.

On the lending side Islamic banks are also required by the Shariah to apply the same principles of profit- and loss-sharing. The two methods that fully satisfy Islamic requirements on loans are Mudarabah and Musharakah arrangements. In both cases lenders share in the profits and losses of the enterprise for which funds are borrowed. The main difference between the two arrangements is that in Mudarabah the financier is not permitted a role in management of the enterprise, while in Musharakah transactions all parties have the right to participate in managerial decision-making. In those cases where profit-loss sharing cannot be implemented a number of alternative instruments for investment and financing are available to banks. These include deferred payment sales or "mark-up", lease-purchase, beneficence (zero return) loan, and the levying of a service charge on loans. While profit-sharing arrangements are considered preferable, Islamic law does permit these other forms of financing methods.

3. Analytical Aspects of Islamic Banking

The replacement of interest-based banking by an alternative system that relies primarily on profit-sharing arrangements raises a number of theoretical questions. The main question is whether Islamic banking is viable, and in recent years there have been a number of studies conceptualizing the basic Islamic banking framework (Khan and Mirakhor, 1987). These studies have shown that an equity-based system, which is what Islamic banking is, can work at least as efficiently and effectively as a debt-based system. As such, the absence of interest does not hinder the functioning of an Islamic bank. Furthermore, an interesting result that emerges from the analytical model developed by Khan (1986) is that an Islamic bank may be better suited to adjust to shocks that can lead to banking crises than conventional bank. The reason is that in an equity-based system, shocks to the asset positions of banks are immediately absorbed by changes in the nominal value of shares (deposits) held by the public in banks. Therefore, the real value of assets and liabilities would be equal at all points in time. In the conventional banking system, since the nominal value of deposits is guaranteed by the bank, an adverse shock to the assets of the bank can create a divergence between the real values of assets and liabilities--leading possibly to negative net worth for the bank--and it is not clear how this disequilibrium would be corrected and how long the process of adjustment would take.

Insofar as monetary policy is concerned, the central bank does lose the ability to set financial rates of return in an Islamic banking system. However, theoretical work has shown that indirect methods through control of credit extended by banks, reserve requirement changes, and varying of profit-sharing ratios can achieve results for monetary policy similar to those in a conventional interest-based system. This is true both for the case of a closed economy (Khan and Mirakhor, 1989) as well as the more realistic case of an open economy (Mirakhor and Zaidi, 1991).

4. Future of Islamic Banking

Practice and theory both show that an Islamic bank is a viable entity. Nevertheless, Islamic banking faces significant obstacles and problems that need to be overcome if further progress is to take place. These include, inter alia, the following.

First, while it has been relatively easy to create a system in which deposits do not pay interest, serious difficulties have been encountered by Islamic banks in the introduction of true profit-sharing arrangements on the lending side. So far it has not been possible to develop a system of contracts between the lender (the bank) and the borrower that would keep monitoring costs at a reasonable level and eliminate moral hazard issues that arise when the lender and the investor have asymmetric information on the profits from the investment. As such, Islamic banks by and large have come to rely primarily on mark-up and leasing operations. This has meant that most Islamic banks' portfolios tend to be concentrated in short-term trade-related assets. This emphasis on short-term financing is bound to have an inimical effect on investment, growth and economic development (Pryor, 1985).

Second, the absence of suitable long-term assets available to Islamic banks is mirrored by a lack of very short-term financial instruments. At present there is no equivalent of an inter-bank market where banks could place, say, overnight funds, or where they could borrow to satisfy temporary liquidity needs. Obviously, the creation of suitable financial instruments is a pressing need as Islamic banks are placed at a distinct disadvantage relative to conventional banks in the range and maturity structure of instruments on both the liability and asset sides.

Third, while in principle the Central Bank can continue to play the same role in regulating banking and financial transactions when dealing with Islamic banks, in practice problems have arisen where such banks operate side-by-side with conventional banks. Should Islamic banks be subject to reserve requirements similar to those of other banks? Are they inherently more or less risky than traditional banks? How can the Central Bank conduct open market operations with securities not paying an interest rate? These questions are extremely important to the efficient functioning of Islamic banking, and need to be resolved.

Fourth, another important issue facing Islamic banks is how to organize their relationships with foreign banks, and more generally, how to conduct international operations. This is, of course, an issue closely related to the creation of financial instruments which would be simultaneously consistent with Islamic principles and acceptable to interest-based banks, including foreign banks.

Finally, Islamic banks face a serious shortage of trained personnel to conduct their operations. Even though the picture has been improving over the years, further expansion of such banks on the scale observed to date will come up very quickly against this constraint. Not only do Islamic banks need qualified managers, but they now are in particular need of finance and investment specialists who could create and develop the full range of financial instruments these banks require to compete with conventional banks.

In conclusion, the rapid expansion of Islamic banking in the past decade or so has demonstrated that there is a sizable market for the product that Islamic banks have to offer. Islamic banks obviously found a niche and suitably exploited it. Overall it is acknowledged that these banks have operated well, although some have encountered problems, such as runs on deposits, large losses, etc. However, in many cases the problems were similar to those faced by conventional banks, and to date no Islamic bank has failed. But Islamic banks operating in a modern economy also face their own particular set of problems. These need to be addressed if Islamic banking is to reach a level that would place it at par with conventional interest-based banking.

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