

The Rationale for The Adoption of

ISLAMIC BANKING IN MUSLIM-MINORITY JURISDICTIONS

INTRODUCTION

What differentiates Islamic banking from conventional banking is not simply the absence of interest payments. The fact that Islamic finance is interest-free does not mean that capital is costless. Unlike in the conventional system where the interest rate determines the cost of borrowed capital, which is pre-determined, the returns on funds provided by Islamic banks are not pre-determined as that would depend on the final outcomes. That said, one must hasten to add that there is much more to Islamic banking than the elimination of interest (*riba*) which is prohibited in Islam. Real sector connectivity and risk sharing principle represent the two important hallmarks of Islamic finance.



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56.50	UNCH	-35.30	38.90	36.76	36.06
87.03	-82 ↓	-85.00	87.95	88.54	87.01
21.17	-87 ↓	+19.53	32.15	21.71	21.13
53.68	+18 ↑	-53.60	53.85	53.84	52.74
14.71	-05 ↓	-14.71	14.74	14.89	14.53
77.39	-18 ↓	-77.00	78.35	77.87	77.34
12.47	-65 ↓	-12.25	13.49	11.10	11.34
	73 ↓	-24.54	24.87	25.26	24.74

The real sector and the financial sector represent the twin pillars of every modern economic entity. These two sectors are so interdependent that one cannot function well without the other. The real sector of the economy is all about production and distribution of goods and services using factors of production, of which capital is an important component. The financial sector funnels financial resources into the real sector through mobilization of savings and financial intermediation. However, the demarcation between the two sectors has become increasingly blurred due to growing sophistication. Innovations have lifted the financial sector into an orbit of its own with a trajectory that may not correspond strictly with that of the real sector. That the stock market trends these days hardly mirror the happenings in the real economy reflects the weak inter-sectoral connectivity that plagues the world economy.

THE REAL ECONOMY AND FINANCIAL SECTOR NEXUS

The relationship between the real economy and the financial sector is critical to economic stability. When one is out of step with the other, stability is disturbed resulting in economic volatility of sorts. The increasing frequency of economic crises the world has witnessed in recent times is an indication of the financial sector's proclivity to veer away from the real sector. While the above explanation of a complex phenomenon is admittedly simplistic, it does serve to underscore the importance of the connectivity between the real economy and the financial sector for economic stability and growth.

The 1997-1998 Asian financial crisis, the global financial crisis of 2007-2008 and the ongoing Eurozone debacle all have one thing in common: the widening rift between developments in the real economy and trends in the financial sector. Thus, for example, the proliferation of derivatives and the securitization of debts have rendered the financial sector highly leveraged. The recent sub-prime credit crisis in the US is an interesting case in point.



As the financial sector is intimately connected to the real sector, the question of “too much money chasing too few goods” that generates inflationary pressure would not arise.

By contrast, in the Islamic paradigm, the real sector and the financial sector of the economy are inseparably linked to each other, with the latter playing a supportive role for the former, which means that the financial sector would not exist on its own. In other words, all financial transactions in the Islamic framework must relate to real sector activities.

ECONOMIC GROWTH AND STABILITY

As is well known, Quranic injunctions forbid *riba* and approve *tijara*. It is pertinent to note that in Islam there is no distinction between “usury” and “interest”, as the term *riba* refers to both, while the term *tijara* – literally translated as “trade” – extends far beyond retail/wholesale trade to envelope the entire supply chain. It then follows that *tijara* is all about the real sector of the economy, namely production and distribution of all intermediate and final products, and creation of jobs. In this order, there would be no such thing as “jobless growth”, as the expansion of the real economy must entail increased employment as well.

As the financial sector is intimately connected to the real sector, the question of “too much money chasing too few goods” that generates inflationary pressure would not arise. For money creation would always be accompanied by increased production, thanks to the real sector connectivity, which would serve to defuse upward pressures on prices. In addition, the Islamic virtue of moderation in consumption would also keep “demand-pull” inflation at bay.

It then follows that economic growth in the Islamic economic model would not be driven by consumption, which is the case with so many economies the world over today. To be sure, the Islamic economy is just as market driven as the secular one, but the Islamic values relating to savings, consumer behaviour, social responsibilities, etc. would ensure that there will be no excessive consumption which would give rise to such other problems as environmental degradation and rapid depletion of non-renewable natural resources.

Thanks to the nexus between the real economy and finance in the Islamic equation, the “multiplier effect” of monetary expansion would be significantly stronger, translating into greater output and employment, while economic growth would be more steady with greater price stability than what is witnessed in today’s world. There would be no such thing as “paper gains” or “paper losses” – just real gains or real losses.

THE MODES OF ISLAMIC FINANCE

As Islamic finance is firmly attached to the real economy, with derivatives playing a somewhat subdued role – primarily to minimise the real sector exposure to risks – the Islamic financial sector would be considerably less leveraged than is the case with conventional finance. In this context, it is important to underline that the various modes of Islamic finance such as *murabaha* (mark-up), *mudarabah* (profit sharing), *musharakah* (profit and loss sharing), *ijarah* (leasing) and *bai-salaam* (production sharing) are all directly connected to the real economy. It is noteworthy that all such modes of financing are free from interest but not costless, where cost would depend on supply and demand for funds based on the sharing of risks and rewards.

Essentially, Islamic finance is all about risk sharing, in sync with the Islamic concept of “balance” in all transactions, in sharp contrast to risk-shifting practices that are so prevalent in conventional finance. What makes Islamic finance so distinctly different from conventional finance is not just the absence of interest payments; equally important is its accent on morality, ethics, transparency and fairness. All these are guided and aided by the centrality of the real economy in the Islamic financial matrix.

Islamic banking is making ripples, if not waves, in many parts of the world. Its assets, deposits and financing are growing at a double-digit pace annually, attracting much international attention, especially in the aftermath of the global financial crisis of 2007-2008 which showed that Islamic banks were generally more stable than their conventional peers. This has prompted the International Monetary Fund (IMF) and the Bank for International Settlement (BIS) to take a closer look into the Islamic banking trajectory.

THE ANATOMY OF ISLAMIC BANKING

The anatomy of Islamic banking is fairly simple, premised on the Qur’an and Sunnah. For example, funds are mobilised based on the concepts of *qard*, *waad*, *wakalah* and *mudarabah*. In the case of *qard*, the Bank is the borrower and the Depositor is the lender, where the principal is guaranteed with no return, whereas in the case of *waad*, the Bank acts as Trustee where the principal is guaranteed and return, if any, is only discretionary. Under the *wakalah* mode, the Bank serves as Investment Agent, where neither capital nor profit is guaranteed and all profits accrue to the investor after deducting the Bank’s fixed and variable fees. Thus, *wakalah* is neither profit-sharing nor loss-sharing, as all profits and losses accrue to the investor, while the return of capital is warranted only if the Bank is found to be negligent or in default of its investment obligations. In contrast, *mudarabah* is a purely profit-sharing arrangement, with no loss-sharing, where the Bank acts as Fund Manager (*mudarib*), where losses fall entirely on the depositor-cum-investor.

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On the reverse side of the coin, the Bank invests the mobilised funds in financing its clients through non-interest based instruments such as *murabaha* (profit margin), *ijarah*, (leasing), *bai'bithaman ajil* (deferred sale), *istisnah* (working capital), and *bai'salam* (product sharing). The Bank also uses the *mudarabah* instrument for financing as well, though not as *mudarib*, but as *rabbul maal* (owner of capital). The bank can also use the profit- and loss- sharing *musharakah* channel for its financing, where the Bank becomes a partner in the joint venture with its client.

To be sure, Islamic banking is not exclusive to Muslims. It is meant for all everywhere except China where it is restricted to Muslims only by decree.

In Malaysia, where Islamic banking has been operating for nearly four decades, non-Muslims account for roughly 40% of Islamic banking clientele. There are two major explanations for the growing non-Muslim interest in Islamic banking. First, the ethical content of Islamic banking appeals to all, cutting across religious boundaries. Second, Islamic banking adds variety to existing range of financial products, with more choices and greater competition, providing more space for financial diversification, innovation and sophistication.



DISCONNECT BETWEEN THEORY AND PRACTICE?

A word of caution, however, is in order. Although Islamic banking, in theory, is technically very different from conventional banking, in practice Islamic banks have come under the shadow of commercial banks in the sense that their products resemble that of their conventional counterparts. For there is an Islamic substitute for every conventional product, which amounts to 'Islamisation' of conventional products through the Shari'ah compliance process. In other words, Islamic banks are offering 'differentiated' products by simply adopting conventional risk and return profile, subject to Shari'ah constraints. So long as Islamic banks remain under the shadow of commercial banks, mimicking conventional risk and return profile, they will only offer depositors returns similar to what conventional banks provide to their depositors and price their products accordingly, resonating the conventional banks' profit maximisation principle, which is antithetical to the overarching Shari'ah objectives.


The story might have been different, if Islamic banking was cast in the mould of cooperative banking instead of commercial banking. In fact, the Islamic banking paradigm is closer to the ideals of cooperative banking than to the principles of commercial banking, notwithstanding the presence of interest or *riba*. Interestingly, several scholars have drawn parallels between Islamic banks and European cooperative banks (e.g. Chapra, 1985; Siddiqi, 2006; El-Gamal, 2006). Co-operative banks are said to be good at accumulating deposits in hard times, thanks to the trust built on serving low-income households, social mandate, best practices, and prudence (Allen & Gale, 1997; Ayadi *et al.*, 2010). Thus, cooperative banks were able to maintain their lending growth during the sovereign debt crisis in the Eurozone (Merilainen, 2016).

In short, the cooperative banking model appears to be largely in consonance with the Shari'ah objectives. Cooperative banks' emphasis on mutuality, trust, customer wellbeing before profits, moderation, prudence, inclusiveness, accessibility, and sustainability resonate Islamic values. What's more, under the cooperative banking model, Islamic banks' depositors will receive higher returns like shareholders. A major difference, however, is that cooperative banks do charge interest, while Islamic banks in the cooperative mould will instead use Islamic instruments that preclude interest payments.

A GAME CHANGER?

Islamic banking potentials in Muslim-minority countries cannot be underestimated. Anecdotal evidence shows that many Muslims stay out of the banking industry for religious reasons. Thus, for example, there is a huge pent-up demand for Islamic banking in the vast Muslim community in India. The establishment of Islamic banking will mobilize substantial cash funds which are now lying idle and release them for productive investments.

The introduction of Islamic banking in Muslim-minority jurisdictions would also add considerable variety to existing banking services for the benefit of all citizens and residents, Muslims and non-Muslims. In this regard, it is important to ensure that Islamic banking will be inclusive, open to all across the board. Islamic banking can be a game changer for the economies dominated by small and medium enterprises (SMEs) which tend to be sidelined by conventional banks which charge high rates of interest and insist on collateral. Experience elsewhere has shown that Islamic banks are more SME-friendly, willing to share risks through profit sharing and leasing modes of financing which do not require collateral.



It is of relevance to note that China, which has a much smaller Muslim population base than that of India, now has two Islamic banks. However, China does not allow non-Muslims to transact with Islamic banks, which is most regrettable. There are signs that China might want to reconsider this policy of confining Islamic banking to Muslims only.

Since Islamic banks have to co-exist with conventional banks in most countries, there is a need for central banks to ensure a level playing field where Islamic banks can compete with conventional banks. Competition must be fair and just. This may require changes in the laws governing financial transactions. The central banks will have to put in place mechanisms to facilitate and nurture Islamic banking.

It would be revolutionary, if some were to opt for the cooperative banking model for Islamic banking, for the European cooperative banking model arguably provides a better fit for Islamic banking than the commercial banking model (Gulzar, 2016; Gulzar et al., 2019).

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